S. HRG. 102-119

JURISDICTIONAL ISSUES IN S. 207, THE CFTC REAUTHORIZATION

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

TITLE III OF THE FUTURES TRADING ACT OF 1991, CONCERNING THE APPROPRIATE REGULATORY SCHEME ON FINANCIAL INSTRUMENTS HAVING ELEMENTS OF COMMODITY FUTURES, SECURITIES, BANKING AND INSURANCE PRODUCTS

APRIL 16, 1991

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JURISDICTIONAL ISSUES IN S. 207, THE CFTC REAUTHORIZATION

TUESDAY, APRIL 16, 1991

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. Let me ask everyone to be seated, and welcome everyone to the hearing this morning.

We're going to get started, because we have a joint session of the Congress later this morning, and that will take some of our members away to that event.

I want to say to some of our witnesses, I appreciate, very much, their scheduling to be here today on short notice.

It was necessary for us to have this hearing because the issue is now before the Senate. The issue before the Senate comes from another committee, but a portion of the issue falls within the jurisdiction of this committee.

And in order to understand precisely what is proposed in that other legislation, we felt it was necessary to have the members who were here today as witnesses come before us, and to testify.

This morning's hearing is on title III of the Futures Trading Practices Act of 1991.

Title III concerns the appropriate regulatory scheme for a broad array of financial instruments that have elements of commodity futures, securities, banking products or insurance products.

Testifying, this morning, will be members of the Working Group on Financial Markets.

And they are:

Alan Greenspan, Chairman of the Federal Reserve;

Robert Glauber, Under Secretary of the Treasury;

Richard Breeden, Chairman, Securities & Exchange Commission; and

Wendy Gramm, Chairman of the Commodity Futures Trading Commission.

The primary focus of this hearing is to determine the extent to which the Working Group on Financial Markets supports S. 207, as reported by the Agriculture Committee, and the proposed amend-

ment developed by the CFTC, which is expected to be offered by Chairman Leahy of the Agriculture Committee.

The witnesses will also be asked their views on a substitute to title III, that is being worked on by Senators Wirth and Bond on this committee, and which the four witnesses at the table have had some opportunity to review.

I scheduled this hearing in light of the letters the Banking Committee has received expressing strong concerns, or opposition to, S. 207.

While I understand that Senator Leahy expects to offer substitute language, many of the concerns expressed in these letters have not been dealt with adequately in that substitute insofar as I'm aware of it.

To date, we have received letters expressing concerns or opposition to S. 207 from, among others:

Alan Greenspan, Chairman of the Federal Reserve;

FDIC Chairman, William Seidman;

SEC Chairman, Richard Breeden;

Mary Shapiro, a Commissioner on the Securities & Exchange Commission, and a former staff member of the CFTC and former general counsel of the Futures Industry Association; and, as well,

Representatives from the Office of the Comptroller of the Currency;

Three former general counsels of the SEC;

The American Bankers Association;

The Securities Industry Association;

The New York Stock Exchange;

The American Stock Exchange;

Fannie Mae, Freddie Mac, as well as numerous others.

And I will be making, as a part of this committee record, today, a number of those letters a matter of record.

So, in the interests of time, and because of the joint session later this morning, I would ask the members—I'm going to call on each member for a brief opening comment—but I would ask that, today, we try, particularly, perhaps, to limit the opening comments.

I'm going to also ask the witnesses to limit their oral testimony to 5 minutes or so, so that we leave time for an exchange with the members, because there's an intense interest in this issue.

And it needs to be developed fully so that we'll have this record available for floor action.

I might say one other thing.

Senator Heinz, who we've paid tribute to before in our first meeting since his tragic death, had a great and keen interest in this subject.

And so that is very much in my mind, and I'm sure in the minds of all my colleagues, as well.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Well, thank you very much, Mr. Chairman, and I appreciate you calling this hearing rapidly, and the witnesses being willing to appear.

As everyone is, by now, aware, we'll begin consideration of S. 207 later today, and title III tomorrow.

However, there have been, as yet, no hearings whatsoever on the language that's now in title III.

Therefore, this hearing is necessary so that we can create at least some record for considering these issues on the floor.

These provisions, which could have a very broad impact on the capital markets, generally, including private transactions and bank, insurance and securities markets, directly affect the jurisdiction of this committee.

In addition, much has been made of the support of farm groups, S. 207.

I certainly understand and appreciate their support for reauthorization of the CFTC, and for reforms necessary to address some of the abuses in the futures markets.

That's what title I and title II are all about.

However, I fail to see how title III, which concerns only hybrid securities and other financial instruments, affects farmers at all.

Mr. Chairman, I note that we have in the room an SEC Commissioner who was previously counsel to the Chairman of the CFTC, and general counsel with the Futures Industry Association, Mary Shapiro.

She obviously has unique perspective to offer on these complex issues.

She recently sent a letter to the committee which suggests that title III may be anticompetitive, and that the approach suggested in the Bond-Wirth alternative could benefit both the securities and the futures markets.

I would ask unanimous consent that her statement be included in the record.

The CHAIRMAN. Thank you, Senator Garn.

Again, I want to——

Senator GARN. I just asked unanimous consent that her letter be included in the record.

The CHAIRMAN. Oh, I beg your pardon.

So ordered.

Senator GARN. Now I'm finished.

Thank you, Mr. Chairman.

The CHAIRMAN. All right, very good.

Again, I want to say to all the members that I would hope that we could keep our statements as brief as possible this morning.

Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Thank you, Mr. Chairman.

Mr. Chairman, there's been a lot of rhetoric about title III of S. 207, the CFTC reauthorization bill, as it was reported from the Senate Agriculture Committee, and with the technical amendments that the administration, the CFTC, and the leadership of the Agriculture Committee have agreed upon.

What I'd like to do this morning, before we hear from our witnesses, is to talk a little bit about what is in this compromise and, even more importantly, what is not in it.

At the outset, it's important to try and keep in mind what is not in the compromise.

It is not a grab for jurisdiction by the CFTC.

Title III does not touch the jurisdictional sections of the Commodity Exchange Act, and it does not, either unilaterally, or in any other way, change the 1982 Shad-Johnson accord.

Instead, what it does is simple and straightforward. It:

1. Gives the Federal Reserve the ability to oversee margins on stock index futures contracts;

2. Overturns a court case that made it clear that IP's are futures contracts, exempting from the Commodity Exchange Act, applications for IP's that had already been approved by the SEC, or which are currently pending at the SEC;

3. Clarifies the CFTC's ability to exempt other products from Commodity Exchange Act regulation;

4. Requires the CFTC to exempt swaps from Commodity Exchange Act regulation, even if the swaps are being handled through a netting agreement, which I know is of particular concern to the distinguished Chairman of the Fed, Mr. Greenspan; and

5. Requires the CFTC to exempt any exotic type deposits that might possibly be under its jurisdiction, those very few deposits that are, in effect, futures contracts, from Commodity Exchange Act regulation.

It does not endorse a pick-your-regulator approach.

Instead, it is built on a principle that is very familiar to this committee: functional regulation, the principle that is the foundation of Federal financial services regulation.

There are some that argue that swaps and hybrid products demand a pick-your-regulator approach, and that it is safe to handle the issue in this way because the customers for these products are institutions.

However, it's worth keeping in mind that the customer base of financial futures and the customer base of swaps, at the very least, substantially overlaps.

In conclusion, Mr. Chairman, I would have preferred a solution arrived at through negotiation between the CFTC and the SEC.

Regrettably, that does not seem to be possible.

Which is why the administration—not this Senator—the administration stepped in and negotiated the language of title III.

The administration did that—not this Senator—with the CFTC.

I will have more to say at a more appropriate time, a lot more.

For now, I look forward to hearing from our witnesses this morning.

And I thank the Chair.

The CHAIRMAN. Very good.

Senator D'Amato, a brief comment from you, please.

OPENING REMARKS OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I'm going to ask that all of my statement be included in the record, as if read in its entirety.

The CHAIRMAN. Without objection.

Senator D'AMATO. And then take the opportunity to just simply touch on one, because it would not be usual for me to pass up the

opportunity for me to speak to the Chairman of our Federal Reserve.

And so, Alan, it's only one brief paragraph.

I would like to, though, to take this opportunity to commend you for managing to get the discount rate down to where it is, as low as 6 percent, albeit at quarter point intervals.

Now that inflation has demonstrated, by all measurable criteria, to have been under control and decreasing, perhaps at least another quarter point is in order.

Now, even if the discount rate is lowered to 5.75, it would still be higher than the low period from August 1986 to August 1987, when it was at 5.5 percent.

I think it should come down to at least 5.5, but albeit, even quarter points, I think the economy needs it desperately.

And I said I would hold myself to that one paragraph.

And so I thank the chairman and my colleagues for listening to me make this talk to you, once again.

[The complete prepared statement of Senator D'Amato follows:]

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Mr. Chairman, I commend you for calling today's distinguished panel of witnesses to discuss title III of the "Futures Trading Practices Act of 1991," S. 207. I join you in welcoming today's witnesses and thanking them for appearing once again to discuss the jurisdictional issues that arise from S. 207.

The question of whether the SEC or the CFTC has jurisdiction over financial products that are not clearly the domain of either regulatory agency is an issue that has had plenty of time to age, but it is an issue that has not improved with age.

Compromises have been worked out between the agencies and discarded. Indeed, it is unfortunate that two such effective agencies could not reach an acceptable compromise that would benefit the market as a whole. Some people have characterized the jurisdiction question over hybrid products, including swaps and stock index participations, as an "inside the beltway issue"—and perhaps rightfully so.

It seems to me that it should be possible to settle the jurisdictional question without sacrificing the integrity of the financial market. Innovative products, such as swaps and IP's, should not be tossed by the wayside just because we cannot decide which agency is the more effective regulator of the product. It should be obvious to the chairpersons of both agencies what makes the most sense and which agency is better suited to regulate new and existing hybrid financial products.

The cost of the failure to see this will be the loss of U.S. market share for trading in these types of financial products. It should be visible to everyone that we need to infuse capital into our markets for financial products, not chase it away.

Before I yield, I would like to address Chairman Greenspan briefly. Chairman Greenspan, I suspect you were just beginning to believe I might conclude my remarks without mentioning the discount rate of interest.

For a change, I would like to commend you for managing to get the discount rate down to its present low rate of 6 percent, albeit at quarter point intervals. Now that inflation is finally decreasing, however, perhaps at least another quarter point is in order. Even if the discount rate was lowered to 5.75 percent, it would still be higher than that infamously low period from August 1986 through August 1987 when it dipped down to 5.5 percent.

From all accounts, we are still in the midst of a credit crunch. A further lowering of the discount rate will have a downward effect on the prime rate. We need to get the prime rate down low enough where consumers can reach it and begin financial stimulation of the economy.

Thank you, Mr. Chairman.

The CHAIRMAN. Very good.

The chairman of the Securities Subcommittee, Senator Dodd.

OPENING REMARKS OF SENATOR DODD

Senator DODD. Thank you very much, Mr. Chairman.

I'll be very, very brief.

I'm anxious to hear the witnesses this morning.

I just sort of regret we're even here, quite candidly.

I thought we had worked this issue out, quite honestly, last fall.

Senators Heinz, Lugar, Leahy and myself, over a period of 3 or 4 months, Senator Bond was involved, the chairman, Senator Garn, others, to put a proposal together that we thought met the concerns of all interested parties.

And, regrettably, that fell out of bed.

And so here we find ourselves bogged down in a matter that is arcane, for most, to put it mildly.

And while I know it's terribly important, in terms of respective agencies, I'm not sure it has as much of an impact—at least, I hope it doesn't—as some of you suggest.

But clearly letters from you, Mr. Chairman, and others indicate that there may be some serious problems if we don't address this issue properly, in terms of competition and the like.

So I very much hope we can get this issue behind us.

My hope would be—and I still hope—that we would resolve this in a manner that doesn't require getting into a massive floor debate on these issues, because I'm not sure our colleagues are going to understand all of this and where we should come out.

And so my hope still is that before this process is over with, we'll come to some conclusion which we can all live with here, and move forward on it, rather than get into a political debate where maybe 2 or 3 percent of the U.S. Senate's Members will understand actually what they're voting on, when we come to this issue.

So I hope maybe this hearing this morning can help us move closer in that direction.

The CHAIRMAN. Very good.

Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, let me review where we are.

I think it is very difficult to debate this issue because very few people understand it.

As a result, it complicates the whole debate because, under those circumstances, strong rhetoric substitutes for logic.

Let me review where this came from, as a debate.

First of all, in 1978, the SEC said that stock index futures had limited utility and no demonstrated economic purpose.

As a result, they opposed allowing stock index futures to trade.

The CFTC allowed stock index futures to trade, and they have become a premier financial instrument in America.

We saw, 2 years ago, something akin to a parent that had given up a child because the child was ugly, only to see the child grow up and become a millionaire. The parent then rushed back to the orphanage and with tears in the eyes, saying, I love that baby. I love that baby. I want that baby back. Give me my baby back. [Laughter.]

Needless to say, Mr. Chairman, the Congress was not swayed by those tears.

The CHAIRMAN. The rights of natural parents supersede the rights of adoptive parents.

Senator GRAMM. Let me remind my colleagues that the House has decided that current law does not need changing.

The House has simply reauthorized the CFTC without addressing this issue, period. And it is not their position that it should be addressed.

The CFTC, the Agriculture Committee, and the Treasury have worked out a compromise.

Even critics of the compromise, such as Chairman Greenspan, say that the compromise is an improvement on current law.

Now the question is: where do we go from here?

Mr. Chairman, my own view is, we have invested far too much time on this issue. More energy, more legislative activity have been wasted on this issue than on any one in my recent memory.

I believe we have a compromise, and it is a compromise based on a principle that this committee has stood for for 15 years. And that is the principle of functional regulation.

The alternative which is being proposed at this late hour is an alternative that would let the offerors of new instruments shop their regulator.

That's not the direction we're moving in with the banking bill. We're moving in exactly the opposite direction.

In fact, both Chairman Greenspan and Chairman Breeden have been fairly consistent supporters of functional regulation.

And yet, here is an eleventh hour proposal, after an agreement is made that is supported by the administration. It is the remarkable proposal that we throw out the regulatory history of the country, and that we simply let people pick their regulator.

Mr. Chairman, maybe we ought to eliminate these two agencies and have one.

But that is a fundamental change that ought not to be made based on a 90-minute hearing, and based on a debate on issues that are not generally understood.

Final point: the compromise bill adds to the jurisdiction of this committee. The compromise bill supported by the administration gives us jurisdiction; it does not take jurisdiction away from us.

The CHAIRMAN. Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you, Mr. Chairman.

I express my sincere appreciation to you and Senator Garn for your leadership on this issue, as well as your perseverance in insisting that this hearing be held, prior to floor action on S. 207.

The issues are too important to treat otherwise.

And with respect to the comment that these issues should not be decided on the basis of a 90-minute hearing, I would suggest that this 90-minute hearing is the first hearing and the only opportunity that we've had to air the proposed compromise, as well as the amendments that are under discussion.

At the outset, let me say that I strongly believe that the CFTC proposed alternative for title III of S. 207 will severely hamper the long-term ability of our financial markets to develop the innovative financial products necessary to meet the capital needs of an expanding U.S. economy, as well as compete in fiercely competitive global markets.

If we are to follow the analogy of the orphanage, let me suggest that under the compromise language reported out of the Agriculture Committee, all of the kids coming into that orphanage would be adopted by overseas parents if we do not change the language that has come out of the CFTC and the Agriculture Committee.

Everyone now agrees that the regulatory structure for financial products must be reformed.

Chairman Greenspan has been particularly eloquent and persuasive on this point.

However, it's crucial that the regulatory structure be flexible enough to allow for growth, as well as innovation and competition.

Simply calling something reform doesn't make it so.

We must also keep in mind, financial products can move overseas without any significant effort.

Thus, we must make sure that U.S. markets are fair, but also attractive to capital.

There are too many examples already where the exclusivity clause of the CEA has driven products abroad, and I fear that that move will continue, unless this proposal is changed.

Senator Wirth and I have developed an alternative to the CFTC's proposal for title III, based on three main concerns about that proposal.

1. Instead of resolving the reach of the Federal commodity laws to provide regulatory certainty, further questions are raised.

2. Financial products now extensively regulated under Federal and State laws appear to be swept under the Federal commodity laws. Bank deposits and loans, insurance products, as well as a wide variety of other products, may now be considered commodity futures and become subject to the duplicative and inconsistent regulation by the CFTC.

When I asked, why not clarify the insurance products as not futures, I was told not to worry, the CFTC does not want them, so then why maintain the exemption.

The amendment provides the certainty of an exclusion which will last beyond the terms of current members of the CFTC and will ensure, in law, that they are not covered.

Third, new so-called hybrid securities would be banned under the current proposal, from trading on securities exchanges unless they could meet a vague, undefined mathematical test.

The Chairman of the Federal Reserve Board has described this test as arbitrary and said that it could "yield anomalous results."

A former general counsel of the Futures Industry Association, now a member of the Securities & Exchange Commission, has stated that the test is not a useful or objective measure.

As a result, these products probably will not trade in the United States.

Clearly, this is no solution.

Mr. Chairman, these issues are vitally important.

The United States is currently the world leader in financial innovation and development, and we should not put ourselves in the position to lose yet another industry to overseas competition.

The CHAIRMAN. Thank you.

Senator Mack.

Senator MACK. I have no opening statement.

I look forward to the testimony from the witnesses.

The CHAIRMAN. Thank you.

Senator Kassebaum.

Senator KASSEBAUM. I have no opening statement, either.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you all.

We're going to go right down the table.

And, as I say, we'll make your full statements a part of the record.

We do want to keep as much time as we can for an exchange back and forth.

I would ask each of you, if you could, to try to summarize, in about 5 minutes time, and then we'll go to questions.

We'll start with you, Chairman Greenspan.

OPENING STATEMENT OF ALAN GREENSPAN, CHAIRMAN, FEDERAL RESERVE SYSTEM

Chairman GREENSPAN. Mr. Chairman, I will summarize, but I'd like a few minutes longer, just to outline a broader position.

The CHAIRMAN. Very good.

Chairman GREENSPAN. I certainly welcome the opportunity to discuss title III of S. 207, the Futures Trading Practices Act of 1991. Although many of the issues presented in this legislation are highly complex, they are important to the competitiveness and soundness of the U.S. financial markets, and I commend the committee for undertaking to explore them fully at this time.

The Board of Governors of the Federal Reserve System has taken particular interest in two provisions of this title, dealing with margins on stock index futures, and the exclusivity provisions of the

Commodity Exchange Act. There are currently three alternative approaches to the latter issue being considered; the approach taken by the Agriculture Committee; another offered by the CFTC; and a third offered by Senators Bond and Wirth. Before I comment on each alternative, I would like to review with the committee some of the history of this issue.

Under the so-called exclusivity provisions of the CEA, futures contracts are subject to the exclusive jurisdiction of the CFTC. The CEA defines the term "commodity" broadly to include not only agricultural products and other goods, but also services, rights, and interests. This language has been interpreted to include contracts for the future delivery of financial interests such as the value of Treasury securities or stock indexes, and can be read to be applicable to many types of financial contracts.

In recent years, a wide variety of new products have been developed to serve investment and risk management needs. Many of these products have some of the economic attributes of futures, and their legality has been called into question by the exclusivity provisions of the CEA. For example, swap markets have grown in the last 10 years to involve transactions with $3 trillion in national principal amount. Unlike exchange-traded futures contracts, these transactions are negotiated on a bilateral basis and customized to the risk management needs of individual customers and can offer significant advantages over standardized exchange-traded products.

The exclusivity provisions of the Commodity Exchange Act have cast a pall over this market, particularly in the area of swaps linked to prices for goods such as oil. Users and financial institutions have been concerned that such transactions might be interpreted to be the economic equivalent of futures contracts under the CEA and therefore be considered illegal off-exchange futures. This specter has almost surely inhibited innovation, not only in the swaps markets, but also in other financial markets. As early as 1989, the Board expressed concern to the CFTC that the provisions of the CEA would prevent the development of new instruments to manage risk and reduce the competitiveness of U.S. financial markets.

The CFTC has taken administrative action to alleviate some of the problems created by the exclusivity provisions, including a policy statement indicating that the Commission would not consider interest rate swaps and certain commodity swaps to be illegal off-exchange futures. In addition, the Commission adopted rules excluding certain hybrid instruments, including bank deposits, from the CEA provided that these transactions met certain financial tests. While these were constructive steps, for which we commend the CFTC, administrative actions alone cannot eliminate the uncertainty created by the exclusivity provisions.

S. 207, as passed by the Agriculture Committee, attempts to address these issues, but does so in a way that is, in my judgment, less than satisfactory. The Agriculture Committee version would provide the CFTC with authority to exempt certain transactions, including swaps and deposits, from the CEA. In order to exempt swap agreements, the CFTC would have to find, after notice and a hearing, that exemption is in the public interest, that only a limited class of participants enters into the transactions, and that they

meet a number of restrictions. The Agriculture Committee version also would provide the CFTC with the authority to exempt bank deposits, if it determines, after notice and a hearing, that the exemption would not be contrary to the public interest.

While providing for certain exemptive authority, the Agriculture Committee version would perpetuate impediments to innovation in hybrids and risk management products and would forestall developments in swap markets that could reduce systemic risk. The restrictions on the swap exemption in the Agriculture Committee version could limit the exemption of some swap agreements currently traded, as well as inhibit the development of new transactions. The Board also is particularly concerned about the potential of these provisions to impede the development of multilateral netting arrangements designed to reduce counterparty credit risk and the resulting systemic risk to the financial markets. The importance of such arrangements was recently recognized in a report released last November by the Governors of the Central Banks of the Group of Ten Countries.

Moreover, such restrictions could lead swap activity and associated netting arrangements to move offshore.

Further, the general exemptive authority in the Agriculture Committee version is narrow, and may prevent the CFTC from making appropriate exemptions. In addition, this version suggests that the CFTC would have jurisdiction over some depository instruments and lending transactions, even though banks are subject to a comprehensive system of Federal regulation designed to ensure the safety of the institutions, and to protect their depositors.

The alternative developed by the CFTC goes further in expanding the CFTC's exemptive authority than the provisions of the Agriculture Committee version, and might be viewed as an improvement over the current law. Nevertheless, this alternative continues to rely on discretionary, and potentially restrictive, exemptive procedures for dealing with swaps and bank deposits rather than the more certain exclusionary approach of the Bond-Wirth alternative. Further, it does not address lending transactions at all.

The alternative language offered by Senators Bond and Wirth, on the other hand, excludes certain swap transactions as well as certain deposit and lending transactions from the coverage of the CEA altogether, thus avoiding problems that may arise from a cumbersome exemptive process, and the potential for revocation of any exemptions granted. It also would provide the CFTC with broader discretionary authority to exempt any instrument if the CFTC determines the exemption is consistent with the public interest. This approach goes further to alleviate financial market concerns created by the provisions of the CEA than the Agriculture Committee or CFTC versions and therefore is in our judgment preferable, particularly in the areas of swaps, bank deposits and lending instruments. The exclusion approach also would remove possible conflicts in regulatory jurisdiction that might arise from the continued CFTC jurisdiction over swaps. At the same time, the limitations of the exclusions ensure that these transactions are subject to Federal oversight, or are limited to sophisticated investors.

Thank you very much, Mr. Chairman.

[The complete prepared statement of Alan Greenspan follows:]

For release at
10:00 a.m. EDT
April 16, 1991

Testimony by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

of the

United States Senate

April 16, 1991

Mr. Chairman, members of the Committee, I welcome the opportunity to discuss Title III of S. 207, the "Futures Trading Practices Act of 1991." Although many of the issues presented in this legislation are highly complex, they are important to the competitiveness and soundness of United States financial markets. Consequently, I commend the Committee for undertaking to explore them fully at this time. There are two provisions of this Title that have been of particular interest to the Board of Governors of the Federal Reserve System, those dealing with margins on stock index futures and those dealing with the exclusivity provisions of the Commodity Exchange Act ("CEA"). As I have noted in previous testimony and Congressional correspondence, the Board supports Federal oversight of margins on stock index futures, which is provided for in S. 207. While we continue to see good reasons for vesting that authority directly with the Commodity Futures Trading Commission ("CFTC") or the Securities and Exchange Commission, we accept the rationale for giving this authority to the Board with latitude to delegate this authority to the CFTC and, of course, would endeavor to discharge that responsibility in a careful and serious manner.

Of more relevance to the hearing today is the matter of the exclusivity provisions of the CEA. I understand that there are currently three alternative approaches to this issue that may be considered; the approach passed by the Agriculture Committee; another approach offered by the CFTC; and a third offered by Senators Bond and Wirth. Each of these approaches revises the

exclusivity provisions of the CEA somewhat differently. I would like to comment on each alternative, but first I would like to review with the Committee some of the history of this issue.

Under the so-called exclusivity provisions of the CEA, contracts for sale of a commodity for future delivery are subject to the exclusive jurisdiction of the CFTC. In addition, transactions in, or in connection with, such contracts can only be conducted on, or subject to, the rules of a contract market designated by the CFTC. The CEA defines the term "commodity" broadly to include not only agricultural products and other goods such as oil, but also services, rights and interests. This language has been interpreted to include contracts for the future delivery of financial interests such as the value of Treasury securities or stock indexes. Although the CEA excludes a number of transactions, including contracts for deferred shipment or delivery and transactions in foreign currency, government securities, and mortgages, it nonetheless can be read to be applicable broadly to many types of financial contracts.

In recent years, a wide variety of new products have been developed to serve the investment and risk management needs of the public. Many of these products have had some of the economic attributes of futures and their legality has been called into question by the exclusivity provisions of the CEA. For example, over the last ten years, the swap markets have developed and grown to involve transactions with $3 trillion in notional

principal amount. The vast majority of these transactions involve interest rates or exchange rates, but in recent years a significant number have involved goods such as oil or precious metals. In a swap transaction, the parties agree to make payments to each other based on changes in interest rates or the value of oil or other products. Unlike exchange traded futures contracts, these transactions are customized to the needs of individual customers and are negotiated on a bilateral basis. Thus, they represent important risk management tools to shield financial institutions and others from fluctuations in interest rates or the prices of the goods or instruments in which they deal. The customizing of these transactions to individual customer needs as to maturity, payment intervals, or other terms can offer significant advantages over standardized exchange-traded products by allowing the customer to adjust its individual risk positions with greater precision.

Nevertheless, the exclusivity provisions of the Commodity Exchange Act have cast a pall over this market, particularly in the area of swaps linked to prices for goods such as oil. Investors and financial institutions have been concerned that such transactions might be interpreted to be the economic equivalent of contracts of sale for future delivery under the CEA and therefore be considered illegal off-exchange futures. Thus, an active market in swaps related to prices of goods did not develop until the CFTC took administrative action to indicate

that it would not view them as illegal off-exchange futures. Even with this exemption, there continues to be concern that developments in the swap markets may run afoul.

This specter has almost surely inhibited innovation, not only in the swaps markets, but also in other financial markets. As early as 1989, the Board expressed its concern to the CFTC that the provisions of the CEA would prevent financial institutions from developing and offering new instruments to manage risk and reduce the flexibility and competitiveness of United States financial markets.

In a number of administrative actions, the CFTC has taken steps to alleviate some of the problems created by the exclusivity provisions of the CEA. These actions have included a Policy Statement indicating that the Commission would not consider interest rate swaps and certain commodity swaps to be illegal off-exchange futures. In addition, the Commission adopted rules excluding certain hybrid instruments, including bank deposits, from the CEA provided that these transactions met certain financial tests. While these were constructive steps, for which we commend the CFTC, administrative actions by themselves cannot eliminate the uncertainty created by the exclusivity provisions, and, therefore, remove the existing impediments to innovation. Administrative actions leave open the possibility that exemptions will be revoked or that private parties will raise the statutory prohibition in an attempt to

invalidate specific transactions. This uncertainty impedes the development of new financial products.

S. 207, as passed by the Agriculture Committee, attempts to address these issues, but does so in a way that is less than satisfactory. The Agriculture Committee version would provide the CFTC with the authority to exempt certain transactions including swap agreements and deposits from the CEA. In order to exempt swap agreements, the CFTC would have to find, after notice and the opportunity for a hearing, that the exemption was in the public interest, the transactions are entered into by a limited class of participants and that they meet a number of restrictions. The Agriculture Committee version also would provide the CFTC with the authority to exempt bank deposits if it determines, after notice and the opportunity for a hearing, that the exemption would not be contrary to the public interest.

While providing for certain exemptive authority, the Agriculture Committee version would perpetuate impediments to innovation in hybrid's and risk management products and would forestall developments in swap markets that could reduce systemic risk. For example, some of the restrictions on the swap exemption included in the Agriculture Committee version have the potential to limit the exemption of some swap agreements currently traded, as well as to inhibit the development of new transactions. The Board also is particularly concerned about the

potential of these provisions to impede the development of multilateral netting arrangements that are designed to reduce counterparty credit risk and the resulting systemic risk to the financial markets. The importance of such arrangements was recently recognized in a report released last November by the Governors of the central banks of the Group of Ten Countries. Moreover, such restriction lead to swap activity and any associated netting arrangements moving offshore.

Further, the general exemptive authority in the Agriculture Committee version is narrow and the CFTC may not be able to make appropriate exemptions and the requirement for a hearing would create a burdensome process that would in itself limit the usefulness of the exemptive authority. In addition, the Agriculture Committee version also suggests that the CFTC would have jurisdiction over some depository instruments and lending transactions, even though banks are subject to a comprehensive system of federal regulation designed to ensure the safety of the institutions and to protect their depositors.

The alternative developed by the CFTC goes further in expanding the CFTC's exemptive authority than the provisions of the Agricultural Committee version, and might be viewed as an improvement over the current law. Nevertheless, this alternative continues to rely on discretionary, and potentially restrictive, exemptive procedures for dealing with swaps and bank deposits rather than the more certain exclusionary approach of the Bond-

Wirth alternative. Further, it does not address lending transactions at all.

The alternative language offered by Senators Bond and Wirth, on the other hand, excludes certain swap transactions as well as certain deposit and lending transactions from the coverage of the CEA altogether, thus avoiding problems that may arise from a cumbersome exemptive process and the potential for revocation of any exemptions that may be granted for these transactions. It also would provide the CFTC with broader discretionary authority to exempt any instrument if the CFTC determines the exemption is consistent with the public interest. The approach taken by this proposed alternative goes further to alleviate the difficulties for the financial markets created by the provisions of the CEA than the Agriculture Committee or CFTC versions and therefore is in our judgment preferable, particularly in the areas of swaps, bank deposits and lending instruments. The exclusion approach also would remove possible conflicts in regulatory jurisdiction that might arise from continued CFTC jurisdiction over swaps. At the same time the limitations on the exclusions ensure that these transactions are subject to Federal oversight or are limited to sophisticated investors.

In conclusion, I believe that it is important that Congress act to clarify the limits of the CEA in a way that permits innovation in United States financial markets so that they can continue to be strong and competitive.

The CHAIRMAN. Thank you very much, Mr. Chairman.
I appreciate your being as specific as you were in that testimony.
Mr. Glauber, we'd be pleased to hear from you now.
We'll make your full statement a part of the record.

OPENING STATEMENT OF ROBERT GLAUBER, UNDER SECRETARY FOR FINANCE, DEPARTMENT OF THE TREASURY

Mr. GLAUBER. Thank you, Mr. Chairman.
I will try to be as brief as I can. I may run a few minutes over.
Mr. Chairman, Senator Garn, members of the committee, as you know, early last month the Senate Agriculture Committee was poised to mark up a bill to reauthorize the CFTC. For nearly a year, the administration has taken the position that such legislation should not be enacted without addressing the crucial, systemwide intermarket issues that were identified in the wake of the market decline in 1987, particularly the lack of harmonized Federal oversight of margins in the "one market" of stocks, stock options, and stock index futures. Unfortunately, opponents of these far-reaching changes had managed to block its consideration in the last Congress, and the stalemate appeared likely to continue in the Agriculture Committee markup.

At this point, the administration decided that we could no longer afford stalemate, especially given the crucial need for harmonized Federal oversight of margins to avoid financial market disruptions. Accordingly, we agreed to a compromise that would resolve the margin issue and at least make some progress on other intermarket issues involving competition between markets.

We believed that such a compromise was the wisest course of action under the circumstances, and the spirit of this compromise was adopted by the Agriculture Committee in title III of S. 207.

While the actual language reported by the committee raised a number of important but unintended technical issues, during the last several weeks we have worked hard to resolve these issues. I'd like to thank the staffs of the SEC, the CFTC, and the Federal Reserve for their technical help, especially since they did not always agree with the substance of the provisions.

We expect a revised version of title III, addressing these technical issues, to be offered as a managers' amendment to S. 207 when it's taken up on the floor of the Senate.

It is Secretary Brady's view that this new title III addresses many of the competing interests in the debate over CFTC jurisdiction, without compromising fundamental public benefits embodied in previous proposals. Most importantly, with the new ability to harmonize margins on the basis of systemic risk, an end to the stalemate will substantially reduce ongoing risk to our financial markets. In addition, improvements to the jurisdictional issue involving hybrid instruments are at least a modest step forward. In that spirit, the administration generally supports new title III.

Under the new title III that was passed by the Agriculture Committee, the Federal Reserve would be given authority to prescribe margin levels for stock index futures, which it could delegate to the CFTC. The CFTC would be authorized to exempt certain products in the public interest, and it would be directed to exempt certain

swaps and deposit hybrids if not contrary to the public interest. Unlike our original proposal in 1990 and the Leahy-Lugar compromise, however, jurisdiction over hybrid commodities would depend on a preponderance-of-value test, rather than allowing hybrid securities to trade anywhere, as we had originally proposed.

While new title III does not go as far as our original proposal, particularly in the area of hybrid instruments, it is timely, constructive, and deserves to be enacted. Four years have passed since the October 1987 market break. While several important steps have been taken to prepare for major market disruptions, including intermarket circuit breakers, large trader reporting, and improved clearance and settlement procedures between markets, critical legislation has yet to be enacted, particularly in the crucial area of intermarket margins. Meanwhile, we have experienced repeated episodes of violent drops in the stock market in the absence of any significant news events. These major market disruptions have severely damaged the confidence of individual investors.

We continue to believe the single most important step Congress can take to address the likelihood and consequences of major market disruptions is to unify regulation of the "one market" of stocks, stock options, and stock index futures. Short of jurisdictional reform, however, we believe the provision in new title III assigning broad authority for setting margin levels for stock index futures to the Federal Reserve Board represents a critical step toward promoting intermarket stability. We strongly support this margin provision, as amended.

Regulatory fragmentation over hybrid commodity instruments also is creating a serious impediment to innovation, as amply demonstrated in the Seventh Circuit's decision concerning Index Participations.

The 50-percent test under new title III, together with new authority to exempt futures contracts and mandatory exemptions for certain swaps and deposit products, represent modest improvements and clarification over the current situation. Although the new provisions on hybrids do not authorize the broader competition in financial instruments that the administration initially proposed, we generally support them in the context of new title III.

If I may just then go on to several comments on the Bond-Wirth proposal.

Let me turn now to the language proposed by Senators Bond and Wirth, as an alternative to the exclusivity provisions of new title III. The margin language, of course, would not be affected. This alternative includes broader general exemptive authority for the CFTC.

Broader exclusions from CFTC jurisdiction for swaps and deposit instruments.

A broader exclusion provision for Index Participations, and the ability of some hybrid instruments to trade either on futures or securities exchanges if approved by the appropriate agency.

This language is obviously closer in nature to provisions the administration included in its original proposal in 1990.

However, the controversy surrounding this type of proposal has failed to result in legislation, delaying passage of crucial safety and soundness measures such as Federal oversight of margins on stock

index futures based on systemic risk. As a result, we believe it is wise at this time to support the compromise embodied in new title III, which addresses the key margin issue and makes modest improvements in the areas addressed more sweepingly by the Bond-Wirth proposal.

As you well recall, Mr. Chairman, on "Black Monday" 4 years ago, we had a crisis on our hands. Despite the progress that has been made to improve market stability, the many studies that have been conducted, and the thorough debate that has taken place, there is much unfinished business—business that is crucial. We cannot continue to keep our financial markets at risk, which they are without Federal oversight of stock index margins.

We believe Congress now has an opportunity to make a significant contribution to the stability and competitiveness of U.S. financial markets. This is the time to move forward, to take the next constructive step, which new title III represents.

Let's not make the best legislation the enemy of good legislation. If we wait for a perfect bill, we may be waiting a long time. Meanwhile, our regulatory system will not be adequately prepared in the event of another market break.

Thank you, Mr. Chairman.

[The complete prepared statement of Robert R. Glauber follows:]

EMBARGOED UNTIL GIVEN
EXPECTED AT 9:30 A.M.

TESTIMONY OF
THE HONORABLE ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

April 16, 1991

Chairman Riegle, Senator Garn, members of the Committee:

I appreciate this opportunity to present the Administration's views on Title III of S. 207, the "Futures Trading Practices Act of 1991."

As you know, early last month the Senate Agriculture Committee was poised to mark-up a bill to reauthorize the Commodity Futures Trading Commission (CFTC). For nearly a year the Administration has taken the position that such legislation should not be enacted without addressing the crucial, systemwide intermarket issues that were identified in the wake of the market decline in 1987 -- particularly the lack of harmonized federal oversight of margins in the "one market" of stocks, stock options, and stock index futures. Unfortunately, opponents of these far-reaching changes had managed to block its consideration in the last Congress, and the stalemate appeared likely to continue in the Agriculture Committee mark-up.

At this point the Administration decided that we could no

longer afford stalemate, especially given the crucial need for harmonized federal oversight of margins to avoid financial market disruptions. Accordingly, we agreed to a compromise that would resolve the margin issue and at least make some progress on other intermarket issues involving competition between markets.

We believed that such a compromise was the wisest course of action under the circumstances, and the spirit of this compromise was adopted by the Agriculture Committee in Title III of S.207. While the actual language reported by the Committee raised a number of important but unintended technical issues, during the last several weeks we have worked hard to resolve these issues. I would like to thank the staffs of the Securities and Exchange Commission, the CFTC, and the Federal Reserve for their technical help, especially since they did not always agree with the substance of the provisions. We expect a revised version of Title III addressing these technical issues to be offered as a managers' amendment to S.207 when it is taken up on the floor of the Senate.

It is Secretary Brady's view that this new Title III addresses many of the competing interests in the debate over CFTC jurisdiction without compromising fundamental public benefits embodied in previous proposals. Most importantly, with the new ability to harmonize margins on the basis of systemic risk, an end to the stalemate will substantially reduce ongoing risk to

our financial markets. In addition, improvements to the jurisdictional issue involving hybrid instruments are at least a modest step forward. In that spirit, the Administration generally supports new Title III.

To understand this compromise, let me provide you with some additional background information. As you will recall, the Administration in 1990 submitted a proposal that in some respects went considerably farther than the current proposal. Among other things, the 1990 bill would have unified regulation of stock and stock derivative products; authorized harmonized federal oversight of margins on such products to take into account systemic risk; and permitted hybrid instruments to trade on both stock and futures exchanges. The 1990 proposal, like the proposed version of Title III, included key recommendations developed by the 1987 Presidential Task Force on Market Mechanisms chaired by Secretary Brady.

Members of this Committee and members of the Senate Agriculture Committee subsequently developed a substitute version that deleted our proposal for unified regulation of equity-related markets but preserved other important elements of the bill in modified form (the so-called "Leahy-Lugar compromise"). We appreciate the considerable efforts that were made to reach this compromise last fall. As you know, however, it was not passed in the closing days of the last Congress, and the

Agriculture Committee was not prepared to report it out of Committee last month.

Under the new Title III that was passed by the Agriculture Committee (and as expected to be amended), the Federal Reserve would be given authority to prescribe margin levels for stock index futures, which it could delegate to the CFTC. The CFTC would be authorized to exempt certain products in the public interest, and it would be directed to exempt certain swaps and deposit hybrids if not contrary to the public interest. Unlike our original 1990 proposal and the Leahy-Lugar compromise, however, jurisdiction over hybrid commodities would depend on a preponderance-of-value test, rather than allowing hybrid securities to trade anywhere as we had originally proposed.

Importance of this Bill

While new Title III does not go as far as our original proposal, particularly in the area of hybrid instruments, it is timely, constructive, and deserves to be enacted. Four years have passed since the October 1987 market break. While several important steps have been taken to prepare for major market disruptions -- including intermarket circuit breakers, large trader reporting, and improved clearance and settlement procedures between markets -- critical legislation has yet to be enacted, particularly in the crucial area of intermarket margins. Meanwhile, we have experienced repeated episodes of violent drops

in the stock market in the absence of any significant news events. These major market disruptions have severely damaged the confidence of individual investors.

We continue to believe the single most important step Congress can take to address the likelihood and consequences of major market disruptions is to unify regulation of the "one market" of stocks, stock options, and stock index futures. Short of jurisdictional reform, however, we believe the provision in new Title III assigning broad authority for setting margin levels for stock index futures to the Federal Reserve Board represents a critical step toward promoting intermarket stability. We strongly support this margin provision as amended.

Regulatory fragmentation over hybrid commodity instruments also is creating a serious impediment to innovation, as amply demonstrated in the Seventh Circuit's decision concerning Index Participations in Chicago Mercantile Exchange v. Securities and Exchange Commission, 883 F.2d 537 (1989). The 50 percent test under new Title III, together with new authority to exempt futures contracts and mandatory exemptions for certain swaps and deposit products, represent modest improvements and clarification over the current situation. Although the new provisions on hybrids do not authorize the broader competition in financial instruments that the Administration initially proposed, we generally support them in the context of new Title III.

Let me now explain our views in more detail on the two basic issues embodied in new Title III -- margins and exclusivity.

Margins

To enhance the safety and soundness of the financial system, the bill gives the Federal Reserve authority to request any contract market to set the margin for any stock index futures contract (or option thereon) at such levels as the Board in its judgment determines are appropriate to preserve the financial integrity of the contract market or to prevent systemic risk. If the contract market fails to do so, the Board can direct the contract market to adopt such margin levels. This would preserve the ability of the futures exchanges to manage margin requirements on a day-to-day basis, and the statute would not require minimum margin levels, which would be left to regulatory discretion.

The result would be that, for the first time since stock index futures began trading in 1982, the federal government would have oversight authority over margins on all stock and stock derivative products -- and not just for the narrow "prudential" concerns of participants in a single market, but also for the broader concern of systemic risk. This systemic risk standard is absolutely crucial to the protection of the integrity of the nation's financial system. Moreover, the Federal Reserve would have the authority to harmonize margins across markets because it

already has ultimate margin authority over stocks and stock options.

We have repeatedly emphasized the problems that are inherent in the current scheme of margin regulation. Currently the futures exchanges and their clearinghouses set margins on stock index futures themselves. The result is a tremendous disparity in margin levels on stock and stock index futures, even though they are part of one market where margin levels on one type of instrument can have a direct impact on the trading and price of other types of instruments. The result has been that futures margins, which have no federal oversight, have often dipped to dangerously low levels.

Those who try to dismiss the need for harmonized margins by claiming that they are unrelated to volatility are simply missing the point. We have never said that average volatility has increased. Our concern is major market disruptions and how to slow them down when the tidal wave starts to form -- not volatility.

There is a broad consensus about the need for federal oversight of margins on stock index futures to limit systemic risk. Indeed, no credible argument has been advanced against federal oversight -- we must have such oversight where the actions of private market participants in a narrow segment of the

market create risks for the financial system as a whole. It is a dangerous practice that is not in the public interest. We need to address this unjustified anomaly, and new Title III does so effectively.

Exclusivity

New Title III also contains five provisions relating to the exclusivity clause in the Commodity Exchange Act -- mandatory exemptive authority for institutional swaps, a 50 percent value test to determine jurisdiction over hybrid commodity instruments, general exemptive authority over futures contracts entered into by institutional participants, mandatory exemptive authority for certain deposits, and the exclusion of exchange-traded index participations that the SEC had approved or for which approval was pending on or before December 31, 1990.

We are well aware of the concerns others have expressed about these provisions. We would underscore, however, that a reasonable compromise that could break the legislative stalemate serves the overall interests of the public and the financial markets. Moreover, instruments that trade today off of futures exchanges would not be affected by the new Title III, and some new hybrid products that might be subject to the exclusivity provision today would not be subject to it under the new legislative language. In short, as described below, each of these five provisions represents at least a modest improvement

over current law.

Swaps. The treatment of swaps under new Title III would improve the current state of the law, which consists of a CFTC policy statement under which traditional swaps are not subject to regulation under the Commodity Exchange Act.

Under the proposed amendment, the CFTC would be required to exempt all swaps that meet certain conditions:

- the CFTC determines that the exemption is consistent with the public interest;
- each party to the swap is an "institutional participant" as defined in the proposed amendment;
- the creditworthiness of the parties is a material consideration in entering into or determining the terms of the swap; and
- the swap is not standardized and "fungible" and it not traded in an exchange setting.

Unlike the policy statement under existing law, the proposed swap provision in new Title III does not preclude, among other things, the netting of payments among parties to swap agreements, which may help to decrease systemic risk. Moreover, eligible swap agreements would be exempted effective as of October 23, 1974, the date of enactment of the Commodity Futures Trading Commission Act, to ensure that the exemption is available for all

eligible swaps, regardless of when they were entered into. We believe the required exercise of exemptive authority for swaps will remove a great deal of uncertainty that has surrounded the swaps market. Indeed, we understand that the International Swap Dealers Association and the Securities Industry Association consider this provision in new Title III to be an improvement over current law.

Hybrid Commodity Instruments. Current CFTC statutory interpretation and regulations, as upheld by the courts, provide the CFTC with broad discretion to assert exclusive jurisdiction over hybrid commodity instruments. This could be upheld even where an instrument resembles a security much more than a futures contract. The 50 percent test of new Title III would exclude from CFTC jurisdiction certain instruments that would otherwise be covered under this broad CFTC authority, such as certain bonds whose return is tied to the price of oil. Moreover, the new test would allow financial instruments to be structured to take advantage of the broader rules.

Exemptive Authority. For the first time, the CFTC would have exemptive authority with respect to futures contracts entered into by institutional participants. While this exemptive authority is not as broad as the CFTC's authority with respect to commodity options, it is a step in the right direction. As the Agriculture Committee report noted, this new exemptive authority

can and should be used to provide greater regulatory flexibility with respect to transactions in existing markets, as well as for new transactions or markets. An example is the Brent crude oil market. The CFTC's statutory interpretation, which concludes that the market is not covered by the Commodity Exchange Act, has been questioned by some, including a dissenting commissioner of the CFTC. In the absence of exemptive authority, the CFTC's interpretation may not remove all doubt concerning the legal status of Brent market transactions, which at least one court has held to be futures contracts. Exempting transactions in the Brent markets would alleviate this uncertainty and free U.S. participants from the competitive disadvantage of off-exchange trading restrictions under the Commodity Exchange Act.

Deposits. The bill also improves current law by mandating the exemption of deposits with futures or options attributes that do not meet the 50 percent test if the deposit or account is subject to comprehensive banking regulation and the exemption would not be contrary to the public interest. This is similar to the provision that was included in the Leahy-Lugar compromise that was agreed to by a number of Senators in the latter part of the last Congressional session. This provision is an improvement over current law, because it clarifies that the CFTC has clear authority to exempt certain deposits from the Act, and indeed, is required to exercise that authority if the new statutory standards are satisfied. Moreover, it must be emphasized that

this provision gives no new jurisdiction to the CFTC over deposit instruments, and certainly does not extend to bank products that have no futures or options attributes.

Index Participations. Regarding index participations, at least five of the eight IPs products that have been approved by the SEC or pending approval will be allowed to trade on securities exchanges. The other three could trade if a licensing agreement between the Chicago Mercantile Exchange and Standard & Poor's Corporation is amended.

While all of these improvements to the exclusivity clause fall short of the Administration's original proposal, the margin provision represents a substantial improvement over current law. At the same time, the exclusivity provisions represent at least a modest improvement over existing law.

The Bond-Wirth Proposal

Let me turn now to the language proposed by Senators Bond and Wirth as an alternative to the exclusivity provisions of new Title III (the margin language would not be affected). This alternative includes broader general exemptive authority for the CFTC; broader exclusions from CFTC jurisdiction for swaps and deposit products; a broader exclusion provision for Index Participations; and the ability of some hybrid instruments to trade either on futures or securities exchanges if approved by

the appropriate agency. This language is obviously closer in nature to provisions the Administration included in its original proposal in 1990. However, the controversy surrounding this type of proposal has failed to result in legislation, delaying passage of crucial safety and soundness measures such as federal oversight of margins on stock index futures based on systemic risk. As a result, we believe it is wise at this time to support the compromise embodied in new Title III, which addresses the key margin issue and makes modest improvements in the areas addressed more sweepingly by the Bond-Wirth proposal.

Conclusion

As you well recall, Mr. Chairman, on Black Monday four years ago, we had a crisis on our hands. Despite the progress that has been made to improve market stability, the many studies that have been conducted, and the thorough debate that has taken place, there is much unfinished business -- business that is crucial. We cannot continue to keep our financial markets at risk, which they are without federal oversight of stock index margins.

We believe Congress now has an opportunity to make a significant contribution to the stability and competitiveness of U.S. financial markets. This is the time to move forward, to take the next constructive step, which new Title III represents. Let's not make the best legislation the enemy of good legislation. If we wait for a perfect bill, we may be waiting a

long time. Meanwhile, our regulatory system will not be adequately prepared in the event of another market break.

Mr. Chairman, that concludes my testimony. I would be pleased to answer any questions the Committee may have.

The CHAIRMAN. Thank you.
Mr. Breeden.

STATEMENT OF RICHARD BREEDEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Mr. BREEDEN. Thank you, Mr. Chairman, and distinguished members of this committee.

This morning's hearing on the exclusivity provisions contained in title III of S. 207 presents a fundamental policy issue concerning the organization of our financial markets.

Consequently, I am especially grateful to you, Mr. Chairman, since the specific language of the proposals in S. 207 has never been considered in congressional hearings, for your determination to see that the issues involved have a chance to be considered prior to action by the Senate.

In case I run out of time, let me say at the outset that I would concur fully and completely in the comments and testimony given this morning by Federal Reserve Chairman Alan Greenspan.

If I run out of time, I will submit the balance of his statement for the record. [Laughter.]

At the outset, let me state that the Securities and Exchange Commission appreciates the understandable desire of many persons to complete work on S. 207.

However, since none of the agencies here before you object to action on the bill, the issue this morning is not whether to amend the CEA to achieve the many reforms contained in that legislation.

The issue this morning also has nothing to do with margins on stock index futures since all the agencies before you evidently now agree that there should be at least the limited Federal oversight of leverage practices that are contained in S. 207.

The one and only one issue before you this morning is the scope and reach of the so-called "exclusivity" provisions of the Commodity Exchange Act.

These provisions are unusual in that they create a legislated monopoly for trading in certain types of commodity future instruments.

Since the law itself was written before the development of futures' contracts on financial instruments and never bothered to define the nature of the instruments governed by this exclusivity in specific terms, it is not entirely surprising that the law has been the source of both uncertainty, litigation, and sadly the exclusion of some products from U.S. markets, as Chairman Greenspan indicated.

Virtually everyone agrees that past assertions of the scope of the exclusivity provisions and litigation in the courts have resulted in an undesirable degree of extension of the reach of this fundamentally anticompetitive provision.

Therefore, that provision has undercut the public interest in competitive and efficient markets more than was necessary to achieve the goals of that clause in trading strictly within the futures markets.

When it acts on S. 207, the Senate will have two possible versions of the "exclusivity" clause before it.

The version contained in S. 207 as adopted by the Agriculture Committee would largely continue the current scope of the exclusivity provisions with some modifications that in places improve, and in places make worse, current Federal statutory law.

By contrast, the alternative proposal put forward by Senators Wirth and Bond would be far more flexible in its application.

While it would not in any way restrict the products that futures' exchanges could offer, the Wirth-Bond proposal would allow vastly greater freedom from banks, securities exchanges, and others who offer products free of the threat of litigation over unforeseen latent issues of futurity in a product.

S. 207 as written would continue to attempt to draw a precise dividing line between futures on the one hand and all other types of instruments on the other, with litigation, regulatory costs, inflexibility, and higher cost of capital the result.

Since we cannot predict what types of products will be developed in the future, continuation of the current basic approach, in which there are two competing pigeonholes into which all products have to be squeezed, will make it unlikely that this issue will be permanently resolved.

On the other hand, under the Wirth-Bond approach, products are recognized as either securities, futures, or a little bit of both.

Where products contain a mixture of both types of instruments, they could be offered in either market without the need for any litigation to determine whether the characteristics were 51 percent of security and 49 percent of future, or only 49 percent of security and 51 percent of future.

That type of arbitrary line drawing would not be necessary with the result that new products would have an absolute certainty that they could be offered in the market for which they were designed.

Bank deposits, swaps, and securities listed on a securities exchange or the NASDAQ would have specific exemptions from the exclusivity principle.

The contrast of these two alternatives presents a clear choice of public policy.

One proposal restricts competition more than is necessary and will perpetuate the disputes and litigation that have undercut various sectors of the financial market.

The other approach is founded on the principle that, where as here there is no risk to customers or market stability, the preferences of market participants and the dictates of creating lower cost capital should govern, not the predilections of regulators or the caprices of litigation.

The basic structure of the current law is seriously flawed.

It assumes, as I suggested, that products are either futures or something entirely different.

The reality is that financial products typically have a range of characteristics.

If they were colors, some of these products would be pure white, and others would be pure black.

But because many products contain varying degrees of capital raising elements and risk shifting elements, many, many products would be neither all white nor all black, but rather one of an infinite number of shades of gray.

S. 207 as it is written does not allow for shades of gray, but rather creates a system in which every product is treated as black or white.

It assumes that each new product is either a future or it is not, and 2 or 3 years of litigation ought to result in a court opinion on which it was.

Alternatively, each new product can be subjected to a regulatory proceeding to determine whether it will be given an exemption, though that cumbersome process too will be slow and costly, and then could be followed by litigation.

The system in the end will be rigid, slow, and costly for many products of banks, securities firms, and possibly others, and it does not need to be so.

I would indicate that we are not talking purely about hypotheticals.

I pulled out this morning an example of a Wells Fargo Bank Certificate that was offered in the United States through the branches of Wells Fargo.

It is offered no more because it was determined that it violated the exclusivity clause.

Let me read a recent printout of some of the offerings in this area:

Bankers Trust Gold Notes, gold-link zeroed coupon notes which are listed in Luxembourg.

Bankers Trust Step-Up Coupon Oil-Link Notes which are listed in Luxembourg.

Refinement International Gold-Linked Bonds which are listed in Luxembourg.

Standard Oil Co. Bonds with attached gold warrants which are listed in Zurich, Basle, and Geneva.

These are securities developed to try to bring the cost of capital down. They are not offered in the United States, and they are not because here we have to go through this pigeonhole exercise that is not required under the laws of any other nation.

We do not object to efforts to try and bring this issue to a halt. We do not object to trying to come to a reasonable compromise. We think that is in the public interest. But what we would like to see is a compromise that, to the maximum possible degree, makes it possible for innovation and competition to thrive.

Ultimately, this important decision is for Congress to decide. The clash of exclusivity and competition presents a far-reaching policy issue, and the flexibility of the structure you determine to adopt will have significant consequences.

Once you have made that decision, however, it is up to the rest of us to put these debates behind us and to work as hard as possible to promote our collective interests in strong and competitive markets where customers will be fairly and honorably treated.

Thank you.

[The complete prepared statement of Richard C. Breeden follows:]

TESTIMONY OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING TITLE III OF S. 207, "THE FUTURES TRADING PRACTICES ACT OF 1991"

BEFORE THE COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS
UNITED STATES SENATE

APRIL 16, 1991

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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Chairman Riegle and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission concerning the "exclusivity" provisions contained in Title III of S.207, the Futures Trading Practices Act of 1991, as proposed to be amended by Senator Leahy (the "Leahy Proposal"). In presenting the Commission's views on the Leahy Proposal, I will also contrast that proposal with an alternative version of the exclusivity provisions that has been suggested by Senators Wirth and Bond. Since the Leahy Proposal concerns fundamental issues that could have a prolonged impact on the competitiveness of the U.S. market for financial services, and since it has never before been considered in any public hearing, I am grateful to you, Mr. Chairman, for your determination to hold this hearing.

The sole question facing us today is the scope and application of the "exclusivity" provisions of the Commodity Exchange Act. Specifically, does the Leahy Proposal represent

good public policy for the future of America's banking, securities and insurance systems, each of which will be directly and substantially affected over time by the exclusivity principle that is at issue? Alternatively, can the Leahy Proposal be improved so that S.207 will have a positive rather than a deleterious impact on these other sectors of the U.S. market? The Commission hopes to be able to assist this Committee in addressing these questions.

The "exclusivity" provisions constitute an express legislative monopoly in the trading of standardized futures contracts. Adopted in 1974 at a time when financial futures did not exist, the exclusivity provisions make trading involving "contracts of sale of a commodity for future delivery" subject to the exclusive jurisdiction of the Commodity Futures Trading Commission ("CFTC"), and make it unlawful to offer or sell in the United States any "contract for the purchase or sale of a commodity for future delivery," except on a regulated futures exchange.1/

1/ 7 U.S.C. §§ 2, 6. Under the Commodity Exchange Act a "commodity" is defined to include all goods and services of any kind other than onions. Because the term "contract of sale of a commodity for future delivery" is not defined in the statute, there is considerable ambiguity surrounding the reach of the exclusivity clause under current law. Indeed, recent CFTC positions and at least one judicial decision suggest that the exclusivity principle may extend beyond traditional exchange-traded futures to bank deposits, insurance contracts, swaps and at least some types of securities.

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At the time the exclusivity provisions were drafted, it was easy to tell a contract in wheat or hog bellies from the common stock of IBM, or from options on individual securities or groups of securities. However, with the advent of financial futures it suddenly became much more difficult to establish when a "stock" or an "option" crossed the line to become a "future."

The current structure of U.S. law can perhaps be best understood by comparing the spectrum of product characteristics to a spectrum of color ranging from pure white to pure black. As is true with the color spectrum, financial products range from pure capital-raising instruments like common stock at one end of the spectrum to pure risk-shifting instruments like stock index futures contracts at the other. In between, products can be designed to include an infinite variety of characteristics of stocks, options and futures. Indeed, a particular instrument may be more attractive due to its securities features to one buyer, and due to its commodities features to another buyer. Thus, as with colors, there are pure whites, pure blacks, and an infinite variety of shades of grey, and beauty is in the eye of the beholder.

Under both the current exclusivity provisions and the Leahy Proposal, financial instruments are treated as if they are pure white, or pure black. The law assumes that there is a point on the spectrum of product characteristics at which the product

acquires a sufficient degree of "futurity" to trigger the exclusivity clause. At that point (whether 1% futurity, 50% futurity, or some other point), the instrument simply may not be offered anyplace other than a futures exchange, whether or not such an exchange actually plans to trade the instrument. Unfortunately, it is impossible to determine where the dividing line between "futurity" and "non-futurity" lies, since that depends on an analysis of the variables of the instrument and how any particular person may value those characteristics. The mix of values between "commodity" and "non-commodity" elements may also shift rapidly as market conditions change. Under both current law and the Leahy Proposal, that decision must ultimately be made by a judge after litigation between the parties to determine whether the forbidden quantity of futurity has been reached.

The exclusivity provisions are an exception from the normal principles of competition in the U.S. financial marketplace. Indeed, if such a general principle had existed in federal securities or banking laws, there would have been a sharply different evolution of the U.S. market. Many familiar products such as money market funds, commercial paper, discount brokerage, CMOs and other securitized receivables, single premium and variable rate annuities and many other products that have enhanced consumer convenience and lowered the cost of capital for

all U.S. businesses would never have been possible if there had been "exclusivity clauses" in federal banking and securities law.

Thus, the breadth of the exclusivity clause is a fundamental issue going to the very heart of the philosophy that should govern the regulatory structure of U.S. financial markets. It is not a question of regulatory "jurisdiction," but rather a of those question of policy that Congress rightly should consider and decide. In the clash between the principle of monopoly trading privileges, which the exclusivity provisions are designed to achieve, and the principle of corpetition in the marketplace, the future vitality of U.S. financial markets will be either positively or negatively affected.

The question of whether the Leahy Proposal represents good public policy for the U.S. financial marketplace poses relatively clear choices. Unfortunately, in the Commission's view the Leahy Proposal will perpetuate uncertainty as to the applicability of the exclusivity provisions to various types of new financial products. That uncertainty has resulted, and in the future will undoubtedly continue to result, in some products being available only in foreign markets. This reduces the vitality of the U.S. financial marketplace as a whole.

The Leahy Proposal also will continue to require litigation and costly bureaucratic proceedings, rather than marketplace

success or failure, to determine what products can be offered in banking, securities and insurance markets. Competition in offering products that combine features of traditional banking, securities and commodities products will be sharply curtailed, thereby directly threatening the attractiveness of U.S. markets to those seeking to raise capital, and almost certainly resulting in a higher than necessary cost of capital.

The Leahy Proposal will also impose new costs on banks to obtain advance approvals from the CFTC for certain deposit instruments, swaps and other products arguably linked in some manner to a commodity. These firms historically have not been required to obtain such approvals, and the requirement to do so will increase operating costs without offsetting public benefits. At a time when this Committee and other in Congress seeking responsible means of reducing the costs of banks in order to strengthen a system under considerable pressure, the Leahy Proposal will result in additional unnecessary regulatory costs for banks.

Similarly, the Leahy Proposal would raise the costs of securities market participants (both exchanges and firms) without creating the slightest improvement to market stability or investor protection. It would sharply limit the ability of U.S. securities exchanges to develop innovative new trading "hybrid" products for the future that contain elements of both stocks and

futures. It could also limit the ability of U.S. global securities firms to conduct certain types of swaps and other businesses in the U.S., and their ability to structure certain types of securities for issuers in the U.S. market.

The costs imposed by the current approach might be justified if they were necessary to produce some discernible public benefit. Throughout the long public debate over efforts to curtail the damage caused by the exclusivity provisions, however, there has not been any articulation of a public benefit that derives from application of the exclusivity clause outside the area of exchange-traded futures. There has not been any explanation of why banking and securities regulation is not adequate to protect the public as it has been doing for decades. No one has explained why securities regulation is not adequate to protect investors in securities, why bank regulation is not adequate for deposit instruments, or why an institutional swap market that is dominated by regulated financial intermediaries needs additional regulation by the CFTC. All we are told is that the futures exchanges will accept no less, and that there is not enough time to solve this problem.

The burden of establishing a public benefit should fall on those proposing to limit competition and innovation in our financial markets. Advocates of the Leahy Proposal argue that it will make the current serious problem slightly better. Though

there are a few arguments to support this view, there is not any question that the exclusivity provisions could be modified to allow much greater flexibility and competition. Extending monopoly trading privileges outside the narrow area of traditional exchange-traded futures should carry a heavy burden of persuasion, but that burden has not been met here.

An alternative and much more flexible approach has been proposed by Senators Wirth and Bond (the "Wirth-Bond Proposal"). The Wirth-Bond Proposal would encourage the development of new products without sacrificing investor protection or imposing any threat to market stability. That proposal would foster financial growth and innovation, without harm to the legitimate objectives of the futures regulatory system, by allowing new hybrid products to be traded in either securities or commodities markets, thereby eliminating fruitless litigation over the status of such new products. The Wirth-Bond Proposal would make it clear that bank deposits, swap agreements, insurance contracts, and loan instruments are not futures contracts subject to the CFTC's exclusive jurisdiction. Finally, the Wirth-Bond Proposal would give the CFTC the necessary exemptive authority to ensure that financial innovation is not impeded.

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I. PROBLEMS CAUSED BY THE EXCLUSIVITY PROVISIONS

A. Barriers to Competition

The U.S. financial markets have traditionally been the most innovative in the world. Banks, securities firms, mutual funds, insurance companies, commodities firms and securities and futures exchanges constantly develop new financial products that are tailored to meet the needs of a particular customer base.

In general, securities firms are permitted to develop products, such as the money market fund and commercial paper, that contain some characteristics of traditional banking products like checking accounts or short term loans. A different situation arises, however, if a new product is asserted to have any attributes of a futures contract. It then falls prey to the exclusivity provisions of the Commodity Exchange Act, which operate as a serious constraint on innovative activity within the U.S. financial markets.

One of the fundamental problems with the exclusivity provisions, as they operate today, is that they potentially affect a wide variety of instruments. In a recent letter to the late Senator John Heinz, Federal Reserve Chairman Alan Greenspan noted that:

> "the development of new financial products may be discouraged by an extension of the coverage of the Commodity Exchange Act, beyond exchange-traded futures and options, to any instruments that have an element of

'futurity.' Interpreted broadly, any financial contract has some element of futurity; hence this provision potentially affects a wide range of existing and new financial products that might be offered outside of the futures exchanges, including some depository instruments...."

The prospect that an expansive interpretation of futurity may be applied to a particular product engenders uncertainty in the financial markets. The developers of new financial products often cannot predict with any degree of certainty whether those products will be regulated by the SEC or the relevant banking regulator, or whether they will be subjected to the regulatory scheme of the CFTC. This is especially true with respect to products that are referred to as "hybrid instruments" because they combine the attributes of traditional securities with some of the characteristics of a futures contract.2/

Most hybrid instruments are not suitable for trading on futures exchanges. Hybrid debt products are generally designed to be privately placed or offered in the over-the-counter

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2/ Hybrid instruments possess, in varying combinations, characteristics of debt, equity, depository, or insurance interests, coupled with some return linked to a commodity. For example, a bank might offer a certificate of deposit where the customer could elect to choose to receive some or all of interest on the CD determined with reference to a stock index, the price of gold or some other commodity. Alternatively, an issuer in the oil, mining or agricultural businesses might seek to raise capital at a lower fixed cost by offering investors a stock or debenture with some additional benefit -- through a warrant or other device -- tied to the price of a major product or raw material.

securities markets, while hybrid equity products seek the broad-based distribution made available through the organized securities markets. For that reason, the choice is not whether these products should be traded under the securities laws or the commodities laws. Rather, the choice is between allowing them to trade on U.S. securities markets or forcing them to trade on foreign markets.

The adverse impact of the exclusivity principle has been described by numerous market participants. In a recent letter, Morgan Stanley & Co. Incorporated stated:

> "Swaps, hybrid securities and similar financial instruments have emerged to meet the real economic needs of market participants. The development of these products is characterized by a high degree of innovation to meet market requirements, and their viability is often highly sensitive to market conditions. A product that makes economic sense one day may no longer make sense just a few days or even hours later. ... [U]nder the language of the CEA, it is often not clear whether these new instruments fall under the jurisdiction of the Commodity Futures Trading Commission (the "CFTC). In some cases, this uncertainty has stifled innovation, forced transactions offshore, increased the cost of capital to U.S. issuers and made the U.S. financial markets less competitive."

B. Incentives For Litigation

Under current interpretations of the Commodity Exchange Act, there is a single line that divides a security, bank instrument or insurance contract from a "future." Those who develop new financial products may be forced to prove in court that their new

product is not on the wrong side of the dividing line. Since the Commodity Exchange Act does not define where this line is -- or even what a futures contract is -- the result is legal uncertainty that leads to costly litigation.

The litigation surrounding index participations ("IPs") vividly illustrates the problems caused by the exclusivity provisions. Securities exchanges developed these products in order to provide retail customers with an opportunity to invest in a basket of stocks without incurring management fees. After the SEC unanimously approved them for trading on securities exchanges, 74 million IPs were sold in a four-month period. These innovative products were eliminated from the American marketplace, however, because the futures exchanges sued to prevent them from trading as securities.

The Seventh Circuit found that IPs contained elements of both a security and a futures contract. As the Court stated:

> "... it is no less a future than it is a security, and no more. It just doesn't fit. Which is the whole point. It isn't supposed to be like something else ...."

The Court then held that the exclusivity provisions preclude any instrument that has elements of a future from trading on a securities exchange. In so holding, the court observed that the current law and its decision "doubtless...gives the futures

markets the opportunity to block competition from an innovative financial product." 3/

The IPs case demonstrates how current law discourages financial innovation by subjecting all new products to the threat of litigation. It also demonstrates that it is impractical to require that innovative products be subjected to a regulatory scheme designed for products of a completely different nature. For many hybrid products, a finding of futurity eliminates them altogether from the American markets. Today the only place that a product similar to an IP can be purchased is on the Toronto Stock Exchange.

C. Unnecessary Regulation

The broad terms of the statutory language, as they have been interpreted by the CFTC, impose unnecessary costs on banks, securities firms, and other entities that are already subject to comprehensive regulation. There is no purpose served by this redundant regulation. As Chairman Greenspan has stated, it simply is not appropriate "for banking activities of federally regulated institutions to be subject to the jurisdiction of the CFTC."

3/ Chicago Mercantile Exchange v. SEC, 883 F.2d 537, 544 (7th Cir. 1989), cert. denied, 110 S. Ct. 3214 (1990).

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The broad provisions of the Commodity Exchange Act have also created unnecessary costs for dealers in swap agreements. 4/ Swaps have become increasingly important in funding and risk management, with the result that, after roughly ten years of activity, the notional principal amount of transactions is approximately $2.5 trillion. As the market has grown and developed, dealers have emerged to serve as intermediaries in swap transactions and to assume or manage the credit risk that a counterparty will not perform its obligations. Currently, most of these dealers are money center banks and other financial institutions.

The history of the relation of the commodities laws to the swap market demonstrates the problem with exclusivity. As the International Swap Dealers Association ("ISDA") explained in a letter to Senator Dodd:

> "The legality of entering into swap transactions has been called into question in the United States because of uncertainties raised by the broad reach of the Commodity Exchange Act (CEA) and its rigid 'exchange trading' requirement. Swaps are one of several products, including bank deposits, hybrid securities, and Brent oil forward transactions, which have been

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4/ A swap is an agreement between two parties to exchange a series of cash flows measured by different interest rates, exchange rates, or prices, with the payment calculated by reference to a notional amount. For example, one institution might agree to pay a fixed interest rate in return for receiving from another institution the payment of a variable rate. Such agreements typically are long-term and are used by corporations, governments and government entities, and financial institutions to manage risk.

jeopardized by the reach of the CEA in recent years. The legal uncertainties and confusion about the applicability of the CEA, and particularly the exchange-trading requirement of the CEA, to swap transactions has had serious consequences for the swap business. This was particularly notable in 1988 and 1989 when, in the wake of the Commodity Future Trading Commission (CFTC) Advanced Notice of Proposed Rulemaking (December 11, 1987) and CFTC enforcement actions, a significant amount of swap activity and innovation moved offshore."

II. WHY THE LEAHY PROPOSAL PERPETUATES THE PROBLEMS

The Leahy Proposal fails to solve any of the existing problems. If enacted, there would continue to be a regulatory regime in which laws designed to govern trading on futures exchange impede innovation by precluding products from being offered in other markets. There would continue to be litigation over the legal status of new products that are alleged to fall within the coverage of the exclusivity provisions. Finally, there would continue to be unnecessary costs imposed on market participants that are already subject to comprehensive regulation.

A. Barriers to Competition

The Leahy Proposal would perpetuate the anticompetitive effect of the current approach by vesting "exclusive jurisdiction" in the CFTC over any hybrid instrument that derives 50% or more of its value from a futures component. The 50% value mechanism would ostensibly create an objective test for determining whether an instrument is a security or a future. In

reality, it would not provide any certainty because different arbiters can measure the value of an instrument in a variety of ways based on different sets of assumptions. As Chairman Greenspan observed in a letter to Chairman Riegle,

> "the approach taken by S.207 will continue to preserve impediments to innovation in hybrids.... The 50 percent value test embodied in the bill is arbitrary, as will be any procedure for determining the value of the commodity component of a financial instrument, and could yield anomalous results for similarly-situated instruments."

A recent letter from Robert E. Rubin, co-managing partner of Goldman Sachs & Co. described this problem:

> "However, in our view, S. 207 does not go far enough. Under the CEA, the offer and sale of hybrid securities that do not qualify for the new statutory exclusion will continue to be effectively prohibited. Securities with a commodity component that equals or exceeds 50 percent of the value of the security will continue to be prohibited in this country despite the fact that they can be, and are now being, issued and sold under the securities laws of other countries. Moreover, the CEA will continue to permit the issuance of debt securities with detachable warrants on foreign currencies while effectively prohibiting the issuance of similar securities linked to warrants on, for example, gold or oil. This leads to an arbitrary and unduly restrictive result despite the fact that, to our knowledge, no material regulatory problems have arisen in connection with the offer and sale of such hybrid securities in the numerous jurisdictions in which they are permitted."

The 50% test established by the Leahy Proposal is not designed to measure whether an instrument is most appropriately treated as a securities, banking, insurance, or futures product.

Instead, it divides instruments on the basis of whether, on the day of issuance, the instrument derives, or is expected to derive, more than 50% of its value from the commodity component.

Under the 50% test of the Leahy Proposal, an instrument whose value on the date of issuance is determined mathematically to be no more than 49% based on the movement of a commodity index (including the stock market) is perfectly legal to trade outside a futures market. However, a 1% shift in value, or the interpretation of value, to a 50/50 mix would render the instrument unlawful unless it was offered on a futures exchange. Thus, developers of new instruments would be relegated to litigating in court whether the product was 51/49 or only 50/50.

It is difficult to discern the logic in this cumbersome approach that requires the precise measurement of what is not objectively measurable. In addition, as market values change, the legality of products could also change completely. Thus, on a given day a company might issue a preferred stock with a warrant based on the price of a commodity that represented less than 50% of total value of the instrument. A day, week or month later, another company seeking to issue a security with the same formula might produce an unlawful result if the price of the commodity had risen slightly. A few days or months later the product could become legal again.

The question is not whether 50% is the right point to draw a line between lawful and unlawful hybrid securities. The question is why the legality of trading in a product should depend on any boundary line. So long as the markets are regulated, and the public is protected, there is no legitimate need to prevent the markets from developing new products that meet the needs of investors. Letting the SEC approve hybrid instruments for securities exchanges, while the CFTC approves hybrid products for the .utures exchanges, would promote rather .han destroy competition. Letting the federal bank and thrift regulators supervise the offering of deposit instruments and, as necessary, the operation of banks in the swap market, would both permit substantially greater competition in the design and offering of new financial products and avoid wasteful regulatory duplication.

The 50% test also is unsuitable for certain products, such as equity hybrid instruments, that cannot be divided into separate parts and measured. These products will simply be eliminated, as is demonstrated by the need for a separate exclusion for index participations.

Though the courts found that the IPs was not a traditional future (or a traditional security), the Leahy Proposal would make lawful only those eight IPs that were approved by the SEC or pending before December 31, 1990. Any new IP proposed by other securities exchanges or based upon different indexes would be

prohibited. Even those exchanges with a grandfathered IP would not be able to modify them in the future, or to develop new IPs based on different indexes. As a result, the Boston Stock Exchange, Pacific Stock Exchange and Midwest Stock Exchange will never be eligible to trade an IPs, while the Amex, Philadelphia Stock Exchange and CBOE may be able to resume trading the IPs product. No one has explained why Congress should enact a law that permits IPs to be traded on some securities exchanges but not on others. No one has explained why it is in the public interest to permit trading in IPs that are based on some indexes but not others.

B. Continued Litigation

The Leahy Proposal would do little, if anything, to reduce the threat or cost of litigation. There would still be a dividing line between lawful hybrid securities and unlawful hybrid securities, based upon a mathematical computation of one attribute -- an instrument's rate of return. Those who develop new financial products would still be forced to prove in court that their new product is not on the wrong side of the dividing line. The futures exchanges would continue to have an incentive to file lawsuits to prevent competitive products from trading.

Moreover, the Leahy Proposal contains vague standards that would provide new grounds for litigation. For example, the general exemptive provision would require an applicant to show

that the exemption would not have a "material adverse effect" on the ability of the CFTC or any contract market to discharge its regulatory responsibilities. This provision raises a number of questions with respect to how the CFTC would measure the impact that an exemption would have on the operation of a contract market. It could be interpreted to include any loss of business.

More generally, all of the exemptive provisions in the Leahy Proposal would require the CFTC to determine that an exemption is "in the public interest." Section 5 of the Commodity Exchange Act requires that designation of a contract market "not be contrary to the public interest." The CFTC traditionally has interpreted that standard to require that futures contracts serve an economic purpose -- that is, that they provide opportunities for hedging or price discovery. If that interpretation was applied to this exemptive language, it is not clear how it would be applied (or why) to an institutional swaps market or a fully regulated bank deposit.

C. Unnecessary Regulation

Throughout U.S. financial history, it has never been necessary for a bank that wished to offer its customers a commodity-linked deposit instrument to obtain more than the approval of the appropriate bank regulatory agency. The Leahy Proposal, however, would elevate CFTC interpretations to statutory law and impose an entirely new obligation on U.S.

banks. In addition to obtaining approval from its banking regulator, the bank would be required to file an application with the CFTC and demonstrate that offering such an instrument would be in the "public interest."

The availability of regulatory exemptions should not be viewed as a cure for the breadth of the statutory language, as the exemptive process would itself impose substantial costs. The banking regulators have ample authority to regulate the offering of commodity-linked deposit instruments, and there is no public interest in subjecting them to the cost and delay of an exemptive process. FDIC Chairman L. William Seidman has stated that:

> "this additional layer of regulation could increase the cost of developing new banking products and services and stifle innovation in the industry."

The Leahy Proposal would also apply a cumbersome exemptive process to swap agreements. It would require applicants for an exemption from the commodities laws to satisfy the CFTC that an exemption would be consistent with the public interest and that it has met all the enumerated requirements. It would specifically require that each party to the agreement be an institution, that the creditworthiness of any party having an actual or potential future obligation under the agreement be a material consideration in determining its terms, and that the swap agreement not be standardized or traded through a

multilateral transaction execution facility (although parties may arrange to net payment obligations).

These provisions of the Leahy Proposal would limit innovation in the swap market. In particular, they would restrict the development of multilateral trading facilities, third-party screen-based systems for negotiating swaps, mark-to-market provisions, and clearance and settlement improvements (other than netting). Appropriate trading and clearing mechanisms can enhance the liquidity and safety of markets, and there is no reason why their introduction in swap market should be prohibited.

III. BENEFITS OF THE WIRTH-BOND PROPOSAL

The Wirth-Bond Proposal would encourage the development of new financial products under responsible oversight. That proposal also would eliminate the need for duplicate regulatory proceedings under the commodities laws for bank, insurance companies, and securities firms. Finally, the Wirth-Bond Proposal would reduce the existing pressures, stemming from the risks of legal uncertainty and protracted litigation, to move innovative financial products to offshore markets.

The Wirth-Bond Proposal would exclude from the CFTC's exclusive jurisdiction instruments that the SEC determines to be securities, or that are listed or traded on a securities exchange

or quoted on an automated interdealer quotation system. This is consistent with the practice of almost 60 years during which the SEC has the responsibility for defining what instruments are "securities" within the meaning of the federal securities laws. This provision would also guarantee that the Commodity Exchange Act would not, in effect, "overrule" the Securities Act of 1933 and the Securities Exchange Act of 1934 by giving the CFTC a veto over the introduction of new products into securities markets.

For other hybrid instruments, the Wirth-Bond Proposal would focus the 50% test on whether an instrument's predominant characteristics (as opposed to its "value") were those of a commodity option or future. Instruments that the Proposal would allow to trade securities exchanges could also trade on futures exchanges, assuming that they met the other requirements of the commodities laws. The Wirth-Bond Proposal would permit index participations to be traded on national securities exchanges or quoted on an automated interdealer quotation service.

The Wirth-Bond Proposal would exclude swap agreements from the commodities laws if they met specified requirements, and those requirements would be designed to permit the market to grow and innovate. Parties would be required to be institutions. The creditworthiness of any party with a payment obligation would be required to be a material consideration, but margining and collateral agreements would be specifically permitted.

The International Swap Dealers Association, in an April 15, 1991 letter to Senators Bond and Wirth, confirmed the superiority of the Wirth-Bond Proposal. ISDA specifically noted that providing an exclusion for swaps from the Commodity Exchange Act was far superior to the exemption provision in S.207. In this regard, ISDA stated that the exclusion "avoids any possible negative implication of an exemption that swaps may be futures contracts." ISDA also noted that by providing an exclusion based only on objective criteria the Wirth-Bond Proposal adds significant legal certainty. Finally, ISDA stated that:

> By requiring a swap agreement to satisfy both a "standardization" test and a "trading" test, neither of which has a statutory definition or a generally understood meaning, the CFTC Proposal contains a notably higher level of uncertainty than [the Wirth-Bond Proposal].

The Wirth-Bond Proposal also would exclude insured accounts offered by regulated financial institutions. The Proposal includes a similar exclusion for commodity-linked loans, thus enabling the regulators of these financial markets to supervise the offering of such instruments.

Finally, the Wirth-Bond Proposal would give the CFTC broad authority to grant exemptions in the public interest and in order to promote innovation and competition, both nationally and

internationally. This would give the CFTC the kind of flexible authority that would permit it to foster financial innovation.

In sum, the Wirth-Bond Proposal treats the financial spectrum as it really exists -- a mix of whites, blacks and greys. While pure securities and pure futures would continue to be traded on the respective securities and futures exchanges, products representing a mixture of characteristics -- the shades of grey -- could be traded in either the securities markets, the futures markets, or both.

III. CONCLUSION

The proposals that I have discussed present Congress with fundamental policy choices. Do you want to promote competition or to build protectionist barriers? Do you want courts and bureaucrats to determine where new products should trade, or should market participants make that determination? Do you want to eliminate jurisdictional disputes or perpetuate them?

The agencies before you today have come down a long road. In the early 1980s, the SEC and the CFTC came to Congress with a jurisdictional accord designed to provide a solution to the problems caused by litigation over new products. That "solution" has clearly failed to fulfill its purpose because it looked "backward" at prior disputes but did not provide a framework for dealing with unforseen future products.

More recently, the SEC, CFTC, Federal Reserve and the Treasury met as a Working Group to develop solutions to market problems. In those discussions all the agencies except the CFTC felt that it was necessary to modify the exclusivity provision. Last year, the Administration developed and sent to the Congress a comprehensive bill that addressed the problems resulting from the exclusivity provisions. Three of the four agencies here today testified in favor of the exclusivity provisions of that bill. With indications that the Administration Bill was unlikely to pass, five Senators from the Banking and Agriculture Committees developed a Compromise Bill. The SEC staff worked with both Committees over a period of six months in developing and refining language at the request of the staff of the Committees. The compromise was supported by the SEC and the Federal Reserve Board, with the Treasury continuing to advocate the Administration Bill.

Then, a few weeks ago, the Leahy Proposal suddenly emerged. It is clearly a step backward. Moreover, it is the kind of backward step that will virtually guarantee that this issue will come before the Congress again in the future. That is because the Leahy Proposal still requires a precise boundary line between products with a nearly infinite range of characteristics, the evaluation and measurement of which is inherently subjective. If we have learned anything in the years since the SEC-CFTC Accord,

it is that innovation in the financial markets will continue. Since we cannot predict today what new products will be developed in the future, attempts to tinker with the boundaries of the exclusivity provisions are doomed to failure.

By contrast, the Wirth-Bond Proposal would promote flexibility. Because it does not require that all products fall within one of two regulatory pigeon holes, experimentation and competition would be able to occur in the market, not the courthouse. By removing barriers to competition, unnecessary regulation and excessive litigation, this proposal would benefit the public interest in strong and flexible U.S. financial markets. Adoption of that proposal would have a far greater chance of permanently resolving this unnecessary debate over protectionism.

If we are not successful in allowing innovation and vigourous competition in our financial markets, capital will cost more for all U.S. businesses. Further erosion may also occur in the stability of U.S. financial firms that employ approximately 2 million Americans. In this area, the price of protectionism will be very high.

The CHAIRMAN. Very good.

I am going to go ahead with Ms. Gramm here.

We have got three other members who have joined us.

I am going to call on them for brief opening comments after we have heard from our last witness.

Dr. Gramm.

STATEMENT OF WENDY GRAMM, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Dr. GRAMM. Thank you very much, Mr. Chairman, and distinguished members of the committee.

I am pleased to appear before you today to present the views of the Commodity Futures Trading Commission regarding title III of S. 207, the Futures Trading Practices Act of 1991.

The initial hearings in this process—the first of many as it turned out—were held more than 2 years ago.

The CFTC is now into its 16th month of operating without a legislative reauthorization, and important futures market reforms have languished.

In recent months, the Commission has worked long and hard to forge a compromise among many dissenting voices representing both the securities and futures industries.

The negotiations have been intense and difficult.

Often the discussions were conducted with a certain degree of skepticism and distrust.

I call it "mutual paranoia."

I am pleased, however, that an agreement has been reached which is supported not only by the CFTC but by Treasury Secretary Brady and the administration.

As you may be aware, the essential elements of title III were agreed to with Secretary Brady prior to the Senate Agriculture Committee's markup on March 6, 1991.

By the way, the Agriculture Committee did hear testimony on February 7, and 20, 1991, on major portions of that bill.

Since the Senate Ag Committee unanimously approved S. 207, discussions have continued among the Treasury Department, the CFTC, the swap dealers, representatives of the securities and futures industries, and others.

These discussions were aimed at clarifying and confirming our mutual intent regarding title III.

The talks concluded last week with the submission of a proposed technical amendment to Senators Leahy and Lugar, and on April 11, 1991, the administration issued its Statement of Administration Policy in support of title III as proposed to be amended by Senator Leahy.

We believe that title III as proposed to be amended by Senator Leahy is the last piece of the puzzle. S. 207 is a good bill.

We have achieved a reasonable, workable compromise that brings regulatory certainty to our financial markets and deals fairly and decisively with intermarket issues.

It will put an end to the regulatory disputes which have delayed passage of CFTC reauthorization legislation since 1989.

I understand a series of allegations have been made about title III that are not true.

Title III as proposed to be amended should not continue to be misrepresented.

Let me first explain what it does do.

Title III reduces the Commodity Exchange Act's regulatory coverage by excluding or exempting some instruments from CFTC's jurisdiction.

It promotes competition by facilitating the introduction of new products with regulatory certainty and without unnecessary litigation.

It provides flexibility in the regulation of many new products.

It confirms the traditional functional regulatory roles of the CFTC and the SEC and the products that we regulate.

There are several things that title III does not do.

It does not grant the CFTC additional jurisdiction. As a matter of fact, it takes some away.

It does not diminish any other agency's jurisdiction. It gives some to them.

It does not change any of the jurisdictional exclusions already in the Commodity Exchange Act.

And it does not rescind any of the regulatory relief that the Commission has previously provided, and Chairman Greenspan has mentioned some of these things.

Now let me turn to some specific provisions in title III to further set the record straight.

Section 302, which is exemptive authority, would enable the CFTC for the first time in 70 years to allow the introduction of economically useful futures products which may be unsuitable for exchange trading.

Some claim this authority is not broad enough to accommodate innovation and competition.

Let me assure you that this authority is sufficiently broad to enable the Commission to exempt as necessary products from the exchange trading requirement while continuing to provide the financial protections and customer safeguards of existing futures regulation.

With regard to swaps and bank deposits, this section of the bill directs the CFTC to specifically exempt certain swaps and regulated bank instruments.

Some claim that the swaps exemptive authority in section 302 is too restrictive and would force legitimate swaps transactions to trade overseas.

Let me be clear.

The CFTC has not and does not intend to stand in the way of allowing the domestic swaps market to develop, nor will it prohibit swap dealers from reducing risk through certain margining and payment netting arrangements.

The technical amendment proposed by Senator Leahy and supported by the swaps industry will resolve any remaining uncertainties in this regard.

Some object that the CFTC, under S. 207, would be granted jurisdiction over the banking activities of federally regulated institutions.

Not true.

The provision on bank deposits currently in title III is virtually identical to that contained in the original version of S. 207, and my understanding is that that provision came from the Banking Committee staff.

No objections were expressed by my fellow regulators to this provision at the Senate Agriculture Committee's hearing on February 7, and 20, 1991.

Although there seems to be some new found concerns, once again let me be clear: The Commodity Exchange Act covers futures products regardless of the seller or issuer, just as securities laws reach some securities even if they are sold by insurance companies rather than securities firms.

However, the Commission recognizes that time deposits, demand deposits, and transaction accounts are generally not subject to the CFTC regulation. And title III does not expand our jurisdiction over such products.

According to this provision, even if traditional banking products may function economically the same as commodity options or futures, title III requires the Commission to exempt them.

Section 303 on hybrid instruments proposes a predominant purpose test to determine whether a hybrid product would be subject to CFTC regulation.

The predominant purpose test looks at hybrids from a purchaser's perspective and divides them into those instruments whose return predominantly reflect an investment in an enterprise, and those which predominantly reflect a commodity price play.

This objective test will reduce the uncertainty that exists under current law and permit the introduction of new products without resorting to litigation.

Critics suggest that the tests will take away the SEC's jurisdiction over stock index options and other securities.

Not true.

Title III actually provides the SEC with more jurisdiction than it has under current law by excluding certain additional hybrid instruments and certain Index Participations from the Commodity Exchange Act.

Other critics say that section 303 is anticompetitive because all hybrids should be traded as securities on securities exchanges.

I do not think so.

Not all products are the same. Futures are not securities.

Securities are not futures.

And Congress established a regulatory regime that recognizes that these products are different.

The predominant purpose test simply applies this functional approach to hybrid instruments.

Hybrid instruments are part traditional commodity futures or options and part something else.

Under this functional approach, the instrument will be subject to the regulatory approach that matches the instrument's predominant component, the biggest component.

Section 304 on index participations would exclude from the Commodity Exchange Act those stock index participations that the SEC

had approved for trading in 1989, or which were pending at the SEC for approval at the end of 1990.

Some claim that no changes could be made to IP's products without losing the grandfather provision.

It is not the intent of title III that all refinements in these IP's would be prohibited. Some changes would be permitted.

In fact, the Commission has also suggested alternative structures for IP's to securities exchanges' officials which would allow IP's-like products to trade legally on securities exchanges.

We have even further suggested cross-registration of securities brokers that would allow them to sell IP's products that were traded on the futures subsidiaries of these securities exchanges.

Title III does not, however, change the court's holding that IP's are futures, nor would it disturb the congressional judgment that futures contracts are to be marketed to the public as futures and regulated by the CFTC and not retailed to the public disguised as securities.

My final comments will focus on the title III alternative proposed by Senators Bond and Wirth.

In general, it includes several more attempts to divest the CFTC of its jurisdiction and would radically alter the regulatory structure put in place by Congress.

A more detailed explanation is attached to my testimony.

Section 302 of the alternative effectively directs the CFTC to allow futures to be traded off-exchange regardless of the identity of the participants or the purpose of the transaction.

This expansive exemptive authority could create market integrity and customer protection problems.

In that regard, it would be analogous to providing that the SEC "shall" permit the sale of unregistered securities to the public regardless of the identity of the issuer or what they intend to do with the public's money.

Section 303 of the alternative proposes a series of imprecise standards that effectively empower the SEC to divest the CFTC of virtually all of its jurisdiction, and eliminates the safeguards of the current futures regulatory scheme.

According to this alternative, if the SEC declared a futures contract currently trading on a futures exchange to be a security, the Commodity Exchange Act would no longer apply to it.

The SEC has historically interpreted the term "security" very broadly, saying at times in the past that Treasury bill futures, Ginnie Mae options, certificates of deposits, interest in pension funds, and even interests in co-op apartments are "securities," and they have lost in the courts.

Given this history, it is not hard to see how using the proposed new test in the Bond-Wirth proposal, the SEC could reach virtually any futures contract and eviscerate a Federal regulatory scheme that has served to protect the futures markets and its participants for over 70 years.

In section 304 of the alternative, yet another attempt is made to shift jurisdiction over stock index futures to the SEC, and to eliminate the safeguards of the current regulatory regime.

Besides providing that IP's are not futures contracts, IP's could be defined by the SEC to include other stock derivatives.

In sum, we find the Bond-Wirth proposal to be a retreat from the administration's recent cooperative efforts to resolve the current jurisdictional and legislative impasse.

In conclusion, Mr. Chairman, title III as proposed for amendment by Senator Leahy represents a carefully structured compromise that preserves the functional regulatory regime that Congress established and that has resulted in vibrant and, yes, innovative financial markets. This is a fair deal. The CFTC and the administration have made significant concessions to arrive here.

No one has gotten everything he wanted, and everybody has given up something.

All the Commissioners at the CFTC agree that it is time for the CFTC to be reauthorized, and we all strongly support title III of S. 207 as proposed to be amended by Senator Leahy.

Thank you.

[The complete prepared statement of Dr. Wendy L. Gramm follows:]

Statement of Dr. Wendy L. Gramm

Chairman

Commodity Futures Trading Commission

Before the Senate Committee on Banking,

Housing and Urban Affairs

April 16, 1991

Mr. Chairman, and distinguished Members of the Committee, I am pleased to appear before you today to present the views of the Commodity Futures Trading Commission regarding Title III of S. 207, the Futures Trading Practices Act of 1991. The initial hearings in this process -- the first of many as it turned out -- were held more than two years ago. The CFTC is now into its 16th month of operating without a legislative reauthorization. Important futures market reforms have languished while securities market reform legislation was allowed to go forward last year unhindered. The Commission has worked long and hard in recent months to forge a compromise among many dissenting voices, representing both the securities and futures industries. The negotiations have been intense and difficult. Often the discussions were conducted with a certain degree of skepticism and distrust. I am pleased, however, that an agreement has been reached which is supported not only by the CFTC, but by Treasury Secretary Brady, the Administration and members of the Securities Industry Association, the Futures Industry Association, the swap dealers and others.

Title III, as proposed to be amended by Senators Leahy and Lugar, is significant because it will put an end to the regulatory disputes which have delayed passage of CFTC reauthorization legislation since 1989. It achieves stated Administration goals of providing more federal oversight over margins on stock index futures and options, and removing the regulatory uncertainties that could impede the development of new and innovative financial instruments. Politically, it seeks to preserve the existing jurisdictions of the regulators, while providing more regulatory flexibility for the CFTC and an objective test to determine where new hybrid products will be regulated in the future.

As you may be aware, the essential elements of Title III were agreed to in principle with Secretary Brady prior to the Senate Agriculture Committee's mark-up on March 6th. Since the Committee's action, discussions have continued among the Department of Treasury, the CFTC, the Federal Reserve Board, representatives of the securities and futures industries and others. These discussions were aimed at clarifying and confirming our mutual intent regarding Title III. The talks concluded last week with the submission of a proposed technical amendment to Senators Leahy and Lugar. On April 11, the Administration issued its Statement of Administration Policy in support of Title III, as proposed to be amended by Senator Leahy.

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In brief, the technical amendment will improve sections 302 and 303. First, several changes in the exemptive authority area will permit the swaps market to continue to develop in a competitive environment while permitting swaps dealers to reduce risk through certain margining and payment-netting arrangements. These changes are supported by the swaps industry, and should address concerns raised by Chairman Greenspan and others. It will also become clear that commodity-indexed deposits in insured banks will be exempted from all requirements of the Commodity Exchange Act. Secondly, the predominant purpose test for hybrid products will be refined to clarify that the CFTC's jurisdiction will not be expanded, nor will any other agency's jurisdiction be diminished.

Allow me now to turn to a broader explanation of Title III, and in the process, attempt to dispel some of the inaccurate representations that have been made about it.

In brief, Title III of S. 207:

- confirms the traditional, functional regulatory roles of the CFTC and the Securities and Exchange Commission (SEC) and the products they regulate;

- promotes competition by facilitating the introduction of new products with regulatory certainty and without unnecessary litigation; and

- o provides flexibility in the regulation of many products.

On the other hand, Title III:

- o does not grant the CFTC any additional jurisdiction;
- o does not disrupt existing trading in any market or product;
- o does not change any of the jurisdictional exclusions already in the Commodity Exchange Act; and
- o does not rescind any of the regulatory relief the Commission has previously provided. In fact, Title III reduces the Act's regulatory coverage by excluding or exempting some instruments from CFTC jurisdiction.

The following is a section-by-section summary and explanation of Title III of S. 207.

Margins on Stock Index Futures--Section 301 of S. 207

Section 301 significantly adds to the role of the federal government in overseeing margins for stock index futures and options. A futures exchange trading these products must file its margin rules with the Board of Governors of the Federal Reserve

System. The Board is empowered to request changes in margin levels if it determines that such changes are appropriate to preserve the financial integrity of the exchange or its clearing system or to prevent systemic risk. If the exchange fails to make these changes, the Board may direct the exchange to alter or supplement the rules as specified in the request. The Board may delegate any or all of its authority to the Commission.

We believe section 301 strikes an appropriate balance between the interests of the exchanges in maintaining their day-to-day control over margin levels and the government's interest in assuring that the exchanges react promptly and appropriately to protect their financial integrity and to prevent systemic risk. Section 301 thus achieves in a more flexible manner the same goals as last year's Administration margin proposals, which were recently reiterated by Chairman Greenspan in his February 7, 1991 testimony before the Senate Agriculture Committee.

No technical amendments were developed for Section 301.

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Exemptive Authority--Section 302 of S. 207

Futures Products

Under the existing Commodity Exchange Act, futures contracts may lawfully trade only on a CFTC-designated exchange. In contrast, commodity options may trade either on or off exchanges in accordance with CFTC regulations. This disparate statutory treatment could prevent the CFTC from permitting the introduction of economically useful new futures products if, for example, they were not suited for exchange trading because of contract size, limited interest or other factors.

The exemptive authority contained in section 302 would eliminate this disparity and give the CFTC needed discretion. For the first time in the 70-year history of federal regulation of futures trading, the Commission would have statutory exemptive authority with sufficient flexibility to exempt certain futures products from the exchange traded requirement and to address new products quickly. We could oversee the development of new market systems with appropriate regulatory safeguards and provide jurisdictional certainty regarding new commodity instruments.

Section 302 permits the introduction of new products when there are sufficient assurances that there will be no adverse effect upon the Commodity Exchange Act's existing regulatory and

self-regulatory provisions. This provision has been misread as protecting the business of futures exchanges. That is incorrect, instead it reaffirms the importance of their statutorily mandated role to safeguard against manipulation and assure adequate delivery and surveillance. This is a quite reasonable standard. It is similar to the SEC's role of assuring that there are appropriate surveillance arrangements in place when new foreign stock index futures or options products are introduced in the U.S.

Swap Agreements

Section 302 also provides specific directives to the Commission regarding exemptions for certain swap transactions.

Since early 1988, the Commission has been working to provide greater certainty to the financial community regarding swaps. In July of 1989 we issued a Policy Statement which recognized a safe harbor from Commission regulation for swap transactions meeting certain criteria. 54 Fed. Reg. 30694 (July 21, 1989). The guidance provided by this Policy Statement has enabled the swaps market to continue to grow. The Commission will further refine the scope of the Policy Statement in the context of the increased exemptive authority for swaps granted under section 302.

Rather than driving business abroad, the additional regulatory certainty provided by this new exemptive authority should facili-

tate the development and marketing of swap products in the U.S. Indeed, this legislation should prevent problems similar to the one which recently occurred abroad, in the United Kingdom, where a decision of its highest court, the House of Lords, invalidated over $1 billion worth of swap agreements.

There have been objections raised that section 302 somehow suggests that swaps are futures and that the exemptive provision is too narrow and fails to recognize netting of payment obligations and other appropriate business practices. In fact, Title III does not provide, and the CFTC has never ruled, that swap products are futures. However, since "swap agreements" are broadly defined in the bankruptcy code, the objective standards for the swaps exemption in Title III are meant to assure that persons do not evade the Commodity Exchange Act by affixing a "swaps" label to a futures contract and trading it on an unregulated exchange. Our discussions with representatives of the International Swaps Dealers Association and the securities and futures industries have confirmed their support for this approach and for the technical amendments to Title III.

Among other things, the technical amendments regarding swaps:

(1) specifically address and allow the netting of payment obligations;

(2) combine the exclusion and exemption provisions for purposes of clarity and to avoid any inference that any particular swap agreements are futures contracts;

(3) assure that eligible swap agreements would be exempt from all the requirements of the Act; and

(4) provide that the exemptions would be effective as of October 23, 1974, the date of enactment of the Commodity Futures Trading Commission Act of 1974, so that they would apply to all eligible swap agreements, regardless of when they may have been entered into.

As modified, Title III should thus assist the swaps market to continue to develop in a competitive and innovative environment.

Deposits in Insured Banks

Section 302 of Title III also directs the CFTC to grant exemptions for certain commodity-indexed and other commodity-valued deposits and accounts. Some concerns have been expressed that this provision suggests there is CFTC jurisdiction over some depository instruments and lending transactions and that Federal bank regulators could be precluded from regulating banking transactions that are exempted by the Commission.

Curiously, even though the bank deposit authority currently in Title III is virtually identical to that contained in the original version of S. 207, no objections were expressed to these provisions by Chairman of the Federal Reserve Board, Alan Greenspan, Undersecretary of the Treasury, Robert Glauber, or Chairman of the Securities and Exchange Commission, Richard Breeden at the Senate Agriculture Committee's hearing in February.

The Commission recognizes that time deposits, demand deposits and transaction accounts are generally not subject to regulation under the Act, and Title III does not in any way expand the Commission's jurisdiction over such products. Indeed, the provision is intended to have just the opposite effect and reduce uncertainty. There may be circumstances in which such traditional banking products may be combined with features or components that function economically as commodity options or futures. Title III requires the Commission to specifically exempt these products from the Act, subject only to a determination that the exemption would not be "contrary to the public interest."

Section 302 thus recognizes that these banking products would remain subject to extensive regulation by federal banking regulators. Indeed, the technical amendments have made clear that CFTC exemptions apply to all the requirements in the Act and that a particular institution's status as insured, regulated or supervised so as to be eligible for the exemption is intended to be an

objective, self-executing standard. Neither prior approval nor findings of any kind by the CFTC would be necessary to qualify for the exemption. The institution's status would be determined under the relevant banking statutes and regulations, no differently than under the current self-executing provision of the Act exempting banks from the commodity trading advisor definition.

It has been suggested that the public interest tests in section 302 would be subject to the caprice or whim of the Commission. In fact, they embody a well-established legal principle. In the Commodity Exchange Act the public interest considerations focus on provisions concerning price discovery, hedging and risk management for those engaged in the business of buying and selling commodities; market integrity concerns such as manipulation and excessive speculation; and, of course, customer protection issues such as segregation of funds, antifraud and private rights of action and reparations. The Commission has had little difficulty devising rules to implement the standard in administering these provisions of the Act. Interestingly enough, the phrase "public interest" also appears over 150 times in the securities laws.

Hybrid Commodity Instruments--Section 303 of S. 207

Section 303 concerns only hybrid instruments. Traditional futures and stock issuances are not affected.

Hybrids are financial instruments that incorporate features of commodity options or futures by virtue of the fact that, for example, payment of principal or interest payments, or both, are indexed to changes in one or more commodity prices or commodity price indices. Hybrid instruments, as the term is used in section 303, do not include index participations or swaps.

In their traditional roles, the CFTC regulates hedging and price discovery instruments; the SEC regulates investments in particular issuers. In the case of "hybrid" instruments which have recently been developed, however, questions of regulatory assignment arise. Hybrids combine the characteristics and functions of more traditional instruments, such as equity or debt securities, futures and options. Experience shows that attempting to determine which regulatory scheme governs these innovative instruments can be very complex under existing law. Nevertheless, the CFTC believes that the functional economic principles of hedging, price discovery and investment can be applied to new products in such a way as to provide regulatory predictability and certainty without restricting innovation.

Under the hybrids provision, CFTC jurisdiction would be governed by a functional regulatory approach based on a "predominant purpose test." This test looks at hybrid instruments from the purchaser's perspective and divides them into those instruments which predominantly reflect an investment in an enterprise and

those which predominantly reflect commodity price. Under this test, the CFTC would have jurisdiction only if, at issuance, the value of the commodity price movement associated with the option and/or futures component is greater than the value of the non-commodity (e.g., note, bond, etc.) component. On the other hand, any instrument in which the non-commodity component predominates would be automatically excluded from CFTC jurisdiction.

This objective standard should reduce the uncertainty that exists under current law and permit the introduction of new products without the threat of litigation that exists today. Assertions to the contrary notwithstanding, section 303 would allow the private sector to develop and market products that meet the predominance test without any need for prior approval from the CFTC. All that is required is the ability to perform a simple mathematical calculation which no doubt could be performed by the same financial wizards that developed the product. The hybrids provision should thus enhance the competitiveness of U.S. financial institutions by encouraging them to be more confident in making expenditures to develop new commodity-related products.

In proposing the hybrids provision to exclude products from its jurisdiction, the CFTC has acted in accord with its regulatory traditions. Contrary to the claims of some, the CEA does not apply, nor has the CFTC sought to extend its jurisdiction over any instrument having a "little bit of futurity." Cash forward

contracts have been excluded from the Act since its inception in 1922. Transactions in certain financial instruments were excluded by the so-called Treasury Amendment in 1974 when the definition of "commodity" was broadened. Early in 1989, we issued a statutory interpretation which recognized an exclusion from Commission regulation for certain hybrid instruments that combine characteristics of futures contracts with debt or depository interests. 54 Fed Reg. 1139 (Jan. 11, 1989). And on July 21, 1989, we issued rules which established an exemption from Commission regulation for certain other types of hybrid transactions that combine characteristics of commodity options with debt or depository instruments and that are subject to other existing federal regulatory frameworks. 54 Fed. Reg. 30684 (July 21, 1989).

The predominant purpose test is a continuation and expansion of this pragmatic approach. In fact, the test excludes more option products from CFTC jurisdiction than under the Commission's existing hybrid rules. Our present rules exempt products where the instrument derives up to 40 percent of its value at issuance from the commodity component. Title III goes further, excluding such instruments when the commodity option component accounts for up to 50 percent of the instrument's value at issuance.

Moreover, the predominance test explicitly excludes from the Act for the first time hybrids with an embedded futures contract. In this context, I would like to point out that the "little bit of

futurity" characterization is inherently misleading. The Act describes a futures contract as a "contract for the purchase or sale of a commodity for future delivery," 7 U.S.C. 6(a). The CFTC's longstanding statutory interpretation of the definition has never mentioned the term "futurity." 50 Fed. Reg. 11636 (Mar. 25, 1985). Indeed, many contracts that have elements of "futurity" clearly are not futures contracts. As noted above, forward contracts -- i.e., contracts for deferred shipment or delivery -- are the most prominent example of a contract with "futurity" that is not a futures contract. Similarly, mortgages and life insurance policies also have elements of "futurity" but have never been considered futures contracts by the CFTC or the courts.

Contracts with "futurity" may or may not be futures contracts. The mischaracterization of "futurity" as a litmus test for identifying the reach of the Commodity Exchange Act only serves to confuse the issue. It distracts attention from the proper interpretation of the Act which requires that transactions be viewed as a whole with a critical eye toward their underlying purpose. The predominance test in Title III avoids simplistic buzzwords like "futurity" and focuses on the purpose of transactions rather than the label one might affix to them.

It has been suggested that Title III would somehow deprive the SEC of its jurisdiction over stock index options and other securities. Nothing could be further from the truth. In fact, by

excluding certain instruments from the Commodity Exchange Act, section 303, in the case of hybrids, and section 304, in the case of index participations, provide the SEC with more jurisdiction than it has under existing law. Further, the technical amendments developed to section 303 specifically clarify that existing exclusions from the Act, such as the exclusion for options on securities and on stock indexes under the Shad-Johnson Accord, continue irrespective of the operation of the new predominant purpose test.

We have also heard some criticism that the 50 percent "value" test in Title III is not useful, that a better test would be whether 50 percent or more of the "characteristics" of an instrument are those of a commodity or a security, and finally that in the CFTC's view of the world all products would fail the predominance test. We find all this rather puzzling. The financial services industry is already familiar with a CFTC hybrids value test. They have, in fact, been using and bringing products to market under just such a test for nearly two years without difficulty.

In contrast, the "characteristics" test proposed by some would only add more complexity to this area. It is difficult to imagine a process that is likely to be less relevant or more confusing to a practical businessman than determining whether more than 50 percent of the "characteristics" of a hybrid are those of a

security or those of a commodity futures or option. By definition, a hybrid contains characteristics of both types of instruments. How exactly does one define "characteristics"? And how do you distinguish them from traits, properties, attributes or inconsequential similarities? This kind of uncertainty is a businessman's nightmare and a litigator's dream come true.

Even assuming you can identify and sort out meaningful "characteristics," simply counting them up as one type or another would elevate form over economic reality and would ignore what is most critical to the investment decision -- the measurement of the relative value of the security and commodity components. As a practical matter, the difference between the predominance test and the "characteristics" test is the difference between a $10 calculator and a $1 million lawsuit. Mathematics may be painful for those who chose law school over an M.B.A., but this mathematical standard provides the certainty that business needs and lawyers dislike.

So that the Committee might see how the predominant purpose test would work in practice, I have attached to my testimony several examples applying the test to both actual and potential hybrid financial instruments.

While some critics have abandoned the notion that all hybrids should be traded as securities, they still advocate changing the law so that hybrids may trade either on securities or futures

exchanges. We submit that not all products are the same. Futures are not securities. Securities are not futures. Different products entail different risks and require different market and regulatory approaches. The predominant purpose test for hybrids simply seeks to assess each instrument based on its predominant value profile as one type of product or another and to let it trade under the more appropriate regulatory regime.

In any event, all U.S. exchanges are already free to compete. The securities exchanges are free to seek designation from the CFTC to trade futures and the futures exchanges are free to seek registration with the SEC to trade securities. In fact, some securities exchanges have subsidiaries that do trade futures.

Stock Index Participations--Section 304 of S. 207

Section 304 incorporates a CFTC proposal to exclude from the Commodity Exchange Act those stock index participations (IPs) that the SEC had approved for trading in 1989 or which were pending SEC approval at the end of 1990. A limited carve-out for these IPs is justified for those securities exchanges which had expended significant resources to develop and introduce IPs prior to the Court of Appeals ruling that IPs are futures contracts. It is not the intent of Title III that refinements in these IPs would be prohibited. And new IPs on any other stock indexes would, of

course, be permitted to trade on futures exchanges or futures subsidaries of securities exchanges under the Shad-Johnson Accord. Title III would not, however, change the Court's holding that IPs are futures. Nor would it disturb the Congressional judgment that futures contracts are to be marketed to the public as futures and regulated by the CFTC; not retailed to the public in the guise of securities.

Section 304 also incorporates the Commission's proposal to use our existing authority to facilitate the registration of any person who is a "person associated with a broker or dealer" or "associated person of a broker or dealer," as those terms are defined in section 3(a)(18) of the Securities Exchange Act of 1934, for the limited purposes of marketing stock index futures (or options thereon) to the public. Since many of these associated persons already have or will gain pertinent futures experience through the sale of IPs on securities exchanges, they may wish to enter the futures industry and become registered with the CFTC to deal in other futures products or activities. Section 304 will facilitate this process. In this regard the Commission expects to consult with the SEC for the purpose of developing, to the extent feasible, comparable procedures and standards regarding the fitness and qualification for registration of futures and securities industry professionals.

No technical amendments were made to section 304.

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In closing, let me devote a few minutes to the alternative to Title III proposed by Senators Bond and Wirth. We have set forth a more detailed anaylsis in a letter to the Committee dated April 15, 1991. Our review discloses a number of very serious problems.

As discussed above, the "characteristics" standard of section 303 is so imprecise as to be totally unworkable. Furthermore section 303 would empower the SEC, under new section 4c(h)(1) of the CEA, to determine that virtually any futures contract is a security. The SEC has historically interpreted the term security very broadly, saying at times that T-bill futures, GNMA options, certificates of deposits, interests in pension funds, and interest in co-op apartments are securities. It is not hard to see how the scenario would develop. With a little creative interpretation, the proposed new 4c(h)(1) test could reach virtually any futures contract and eviserate a federal regulatory scheme that has served to protect the futures markets and its participants for 70 years.

Also, by creating an unneeded exclusion for insurance products and bank loans (over which the CFTC has never asserted jurisdiction), new section 303 creates a loophole for fraud. By structuring off-exchange futures products in the guise of "loans", con men could insulate themselves from the Commission's enforcement powers.

New section 302 would allow exemptions from the Act's cornerstone exchange-trading requirement with no standards whatsoever, regardless of the potential effect on the public and the purposes of the Act.

Finally, new section 304 would allow the SEC to classify virtually any stock derivative as an IP essentially giving the SEC jurisdiction over stock index futures. This proposal has been debated for two years now and has not been widely embraced.

More detailed comments concerning the Bond-Wirth proposal are attached in a letter to Senators Bond and Wirth, but in closing I feel it is important to emphasize that each of these three sections (302, 303, 304) would wipe out much of the longstanding and successful regulatory structure for the futures industry in this country. Together they could wipe out the entire system. It would be hard to overestimate the potential for customer harm, financial instability, litigation, and regulatory uncertainty which would emerge from such a development.

Thank you again for the opportunity to describe Title III S. 207. I will be happy to answer any questions.

APPENDIX A

Examples Illustrating Implementation of the CFTC Hybrid Test

Following are several examples illustrating the application of the predominant purpose test. The first three are generic examples of hybrid instruments that have embedded futures and commodity options. Specific examples are then given where the test is applied to two previously issued instruments including the SOHIO oil-indexed notes and the SallieMae PERLS instrument.

Example #1

Hybrid Instrument Containing a Commodity Option

In the first example we consider a generic example of how the predominant purpose test would apply to a hybrid instrument containing a commodity option.

Consider a firm that issues a hybrid commodity instrument where the principal amount to be paid at maturity is indexed to the appreciation in the price of gold. The instrument will be sold to investors at a par amount of $1000, will mature in five years and will pay a coupon rate of interest of 6 percent per year. The amount to be paid at maturity will equal the principal amount of $1000 plus an additional amount equal to 2.5 times the price of gold at the maturity date (P_T) in excess of $400, if any. To summarize:

Hybrid Issuance Price	Par ($1000)
Term to Maturity	5 years
Principal Amount	$1000
Coupon Rate	6 percent
Equivalent Yield	10 percent
Commodity Option Payment	2.5 times MAX (P_T - $400, 0)

To illustrate the investor's payoff at maturity, if gold is selling for $420 at the maturity date, then the investor would receive $1000 plus 2.5 times $20 ($420 - $400) which equals $1000 plus $50 or $1050. This instrument can thus be viewed as consisting of a bond plus a commodity option. The potential additional return at maturity, depending upon the price of gold, is a commodity option because the purchaser receives back, at a minimum, all of the principal.

Had the same firm decided to issue a similar bond, but one without the commodity play on gold, it would be required, based on its credit rating and current market rates, to offer investors a 10 percent annual return (equivalent yield). Under these circumstances, a five-year bond paying a 6 percent coupon rate of interest and priced to yield a 10 percent annual return would sell for about $845. Thus, the difference in the selling price of the two instruments of $155 ($1000 - $845) can be attributed to the value of the commodity option component. Alternatively, option pricing models or other procedures to estimate directly the value of the commodity option component may be employed and would give a similar value ($155).

As shown above, the value of the expected commodity price play associated with the commodity option ($155) is less than the value of the bond component ($845). Expressed as a proportion of the hybrid instrument's total value (in this case, the price paid for the instrument) at the date of issuance, the value of the commodity option is $155/$1000 or about 15.5 percent. Therefore, since the hybrid instrument does not derive more than 50 percent of its value from the commodity option, it would not fall within CFTC jurisdiction.

Example #2

Hybrid Instrument Containing an Embedded Futures

In the second example the predominant purpose test is applied to a hybrid instrument having a futures component. Similar to the previous example, the investor's payoff at maturity is indexed to the price of a commodity. However, the indexing is not one-sided as is the case with a commodity option. Instead, the investor's payoff may be decreased as well as increased depending on fluctuations in the price of the commodity. This is a characteristic of a futures component.

Consider a firm that issues a hybrid commodity instrument containing an embedded futures. Current interest rates are 10 percent and the instrument has a five-year term to maturity. Upon maturity, the investor will receive the principal payment of $1000 (the bond component) plus or minus the difference between the then prevailing price of oil in five years (P_T) and a pre-determined reference price of $25 per barrel, times 40 barrels (the futures component). To summarize:

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Hybrid Issuance Price	$621
Term to Maturity	5 years
Principal Amount	$1000
Coupon Rate	0 percent
Equivalent Yield	10 percent
Commodity Futures Payment	40 times (P_T - $25)

As constructed this instrument contains a futures contract because the commodity price play is two sided: if the price of oil in 5 years goes up above $25 per barrel, the purchaser gets back more than the $1000 principal amount; if oil goes down, he will receive less than $1000 back.

The bond component of the instrument is, in effect, a five-year, zero coupon bond with a face value of $1000. Based on the firm's credit rating and a market rate of interest of 10 percent (equivalent yield), the current (discounted) price of such a five-year bond is $621.

To accurately value the expected commodity price play associated with the embedded futures, we simply translate the futures into its "synthetic futures" equivalent -- a theoretical short put option and a long call option. Assume that the computed values of the put and the call each equal $255. Thus, to measure the commodity price play associated with the futures contract, the absolute values of the put and call are added to equal $510 ($255 plus $255).

As the value of the commodity price play associated with the futures ($510) is less than the value of the bond component ($621), this particular hybrid instrument would not fall within CFTC jurisdiction.

If, on the other hand, the principal payment at maturity had been indexed to 60 barrels rather than 40 barrels of oil, the value of the commodity price play associated with the futures contract would have been larger and equal to $765 (60/40 times $510). As the value of the commodity price play ($765) is now greater than the bond ($621), the hybrid instrument would then be subject to CFTC jurisdiction.

Example #3

Hybrid Instrument Containing both a Commodity Option and Futures

The first two examples presented situations where the hybrid instrument contained a commodity option and an embedded futures, respectively. The next example analyzes a hybrid instrument that

contains both.

Consider a firm that issues a hybrid commodity instrument that has both a futures and a commodity option embedded in a bond. Assume that current interest rates are 10 percent and the instrument has a five-year term to maturity. Upon maturity, the investor will receive $1000 (the bond) plus or minus the difference between the prevailing price of oil in five years (P_T) and a predetermined reference price of $25 per barrel, times 40 barrels (the futures). However, if the price of oil rises above $35 a barrel, the payment will be capped at $400 based on a $35 per barrel calculation (the commodity option component). To summarize:

Term to Maturity	5 years
Principal Amount	$1000
Coupon Rate	0 percent
Equivalent Yield	10 percent
Commodity Based Payment	40 times (P_T - $25), subject to a $400 cap

This hybrid instrument can be viewed as a five-year, zero coupon bond having a face value of $1000, and containing a futures contract tied to the price of oil subject to a cap which limits the investor's maximum potential payment at maturity to an additional $400. (A cap is another way of saying an option). Based on the firm's current credit rating and a market interest rate of 10 percent, a five-year zero coupon bond would sell for $621.

To accurately value the expected commodity price play associated with the embedded futures and option, the futures is first translated into its "synthetic futures" equivalent -- a theoretical short put option and a long call option. Let the computed values of the short put (representing the value associated with a potential fall in oil prices below $25) and the long call (representing the value associated with a potential increase in oil prices above $25) each equal $255.

Next, because the payment received from a rise in oil prices is capped when oil reaches $35, the investor in essence is short an additional call option having a $35 strike price. Assume that the value of this short call option equals $200. Because the cap eliminates any additional commodity price play for oil prices above $35, the commodity play value associated with potential increases in oil prices above $25 is reduced from $255 to $55 ($255 - $200).

Thus, the total absolute sum of the commodity price play will equal $55 (for potential increases in oil prices) plus $255 (from potential decreases in oil prices) or $310. Because the value of the commodity price play associated with the futures and option ($310) is less than the value of the bond component ($621), this particular hybrid instrument would not fall within CFTC jurisdiction.

Example #4

SOHIO Oil-Indexed Notes

The next two examples apply the predominant purpose test to two hybrid instruments issued in recent years that contain commodity option and/or futures components. These instruments are the Standard Oil of Ohio (SOHIO) oil-indexed notes and the SallieMae "Principal Exchange Rate Linked Securities" (PERLS).

In the summer of 1986, Standard Oil of Ohio (SOHIO) issued a hybrid commodity instrument indexed to the price of oil. The instrument had a 4 1/2 year maturity and had no stated rate of interest. At maturity investors were to receive a par amount of $1000 plus an additional amount equal to the price of a barrel of West Texas Intermediate crude oil in excess of $25, times 170 barrels. However, if the price of oil at maturity (P_T) rises above $40 a barrel, the payment will be capped at $2550 based on a $40 per barrel calculation (the commodity option component). The hybrid instrument was sold to investors for $970. This instrument can be viewed as being a bond with an embedded commodity option. To summarize:

Hybrid Issuance Price	$970
Term to Maturity	4.5 years
Principal Amount	$1000
Coupon Rate	0 percent
Equivalent Yield	9.9 percent
Commodity Option Payment	170 times MAX (P_T - $25,0), subject to a $2550 cap

A similar non-hybrid instrument issued by SOHIO at that time, was priced to yield investors an annual return of 9.9 percent. Under these circumstances, a pure discount bond with a 4 1/2 year maturity, a $1000 face value, and priced to yield a 9.9 percent annual return would sell for $654. The difference between the selling price of the two instruments of $316 ($970 - $654) can be attributed to the value of the commodity option. Alternatively, option pricing models or other procedures may be employed to directly estimate the value of the commodity option component and would give a similar value ($316).

As shown above, the value of the expected commodity price play associated with the option ($316) is less than the value of the bond ($654). Expressed as a proportion of the instrument's total value at the date of issuance, the value of the commodity option is

about 33 percent ($316/$970). Therefore, since the instrument derives less than 50 percent of its value from the embedded commodity option, it would not be subject to CFTC jurisdiction.

Example #5

SallieMae PERLS

The next example looks at the 12 1/8 Percent Principal Exchange Rate Linked Securities (PERLS) which were issued in March 1987 by the Student Loan Marketing Association (SallieMae) and were set to mature on March 20, 1990. This hybrid instrument was constructed such that the investor's payoff at maturity was dependent on fluctuations in the value of the Australian dollar relative to that of the U.S. dollar.

The PERLS instrument was issued in March 1987 by SallieMae. The instrument had a three-year term to maturity and a 12 1/8 percent coupon rate of interest with interest payable semiannually in U.S. dollars based on the face amount of the instrument ($1000). At maturity the investor was to be paid an amount equal to the U.S. dollar equivalent of A$1452 (Australian dollars). This is also to say that at maturity the investor would receive the principal payment of $1000 plus or minus the difference between the then prevailing U.S./Australian dollar exchange rate in three years (P_T) and a predetermined exchange rate of $.6887, times 1452. Therefore, the payoffs on this instrument can be characterized as a bond with an embedded long futures contract. To summarize:

Hybrid Issuance Price	Par ($1000)
Term to Maturity	3 years
Principal Amount	$1000
Coupon Rate	12 1/8 percent
Equivalent Yield	8.75 percent
Commodity Futures Payment	1452 times (P_T - $.6887)

At approximately the same time, the yield provided to investors on a similar instrument but one without the principal indexed to the value of Australian dollars, was about 8.75 percent per year. Therefore, at the date of issuance, the value of the bond component of the instrument is $1091 which is the value of a three-year, 12.125 percent coupon bond priced to yield 8.75 percent.

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The futures component of the instrument can be theoretically translated into its "synthetic futures" equivalent, a long call option and a short put option. Values for the put and call options can be determined based on market conditions as of the date of issuance. The values of the call and put option are $21 and $124, respectively. Thus, the sum of the absolute values of the put plus the call, or the expected commodity price play associated with the futures contract, is $145, which is less than the value of the bond component ($1091). Therefore, the hybrid instrument would not fall under CFTC jurisdiction.

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581
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April 15, 1991

Wendy L. Gramm
Chairman

APPENDIX B

Honorable Christopher S. Bond
Honorable Timothy E. Wirth
Committee on Banking, Housing,
and Urban Affairs
Washington, D.C. 20510-6075

Dear Senator Bond and Senator Wirth:

I am responding to your request for the comments of the Commodity Futures Trading Commission (CFTC) on your proposed alternative ("Bond-Wirth Alternative") to Sections 302, 303 and 304 of Title III of S. 207, as reported by the Senate Committee on Agriculture and the technical amendments that we forwarded to that Committee on April 9, 1991.

As you know, the Commission, the Agriculture Committee, the Treasury Department, the Federal Reserve Board, representatives of the futures, securities and swaps industries, and others affected by the legislation have devoted many hours of intense negotiation to reaching the compromise embodied in Title III of S. 207. The Commission believes that Title III of S. 207 will bring regulatory certainty to our financial markets, deal fairly and decisively with intermarket issues and permit the Commission to devote its full energies to carrying out its regulatory duties. The Bond-Wirth Alternative would allow the transfer of all of the jurisdiction of the CFTC to the SEC. By weakening or destroying the existing regulatory system for futures, it would create, rather than reduce, regulatory uncertainty and inspire, rather than forestall, litigation.

Section 302--Exemptive Authority

The extremely broad exemptive authority proposed in the Bond-Wirth Alternative amounts to a directive to the Commission to allow futures to be traded off-exchange regardless of the identity of the participants and the purpose of the transaction. In this regard, the Bond-Wirth Alternative is analogous to providing that the Securities and Exchange Commission (SEC) "shall" permit the sale of unregistered securities to the public regardless of the identity of the issuer and regardless of what the issuer intends to do with the public's money. We believe that the expansive exemptive authority in the Bond-Wirth Alternative is inappropriate and, indeed, could endanger market integrity and engender customer protection problems.

The Commodity Exchange Act requires that futures contracts trade only on CFTC-designated exchanges. This provision helps to assure that futures trading will serve its important economic purposes of risk transfer and price discovery. Thus, S. 207 operates from the premise that the exchange trading requirement exists to protect futures customers and the integrity of the market, and that exemptions to this requirement should be granted cautiously. S. 207 would allow exemptions to be granted from the exchange trading requirement only after advance notice and opportunity for comment, and only when the transactions to be entered into are in connection with a line of business or for risk management and hedging purposes. These safeguards are absent from the Bond-Wirth Alternative.

Section 303--Hybrid Commodity Instruments, Swap Agreements, Demand Deposits, Time Deposits, and Insurance Products

Existing law to determine the jurisdictional assignment for hybrid financial products that combine the elements and functions of futures or options with, for example, debt or equity securities is unclear and creates uncertainty. For this reason, the Commission proposed and supports S. 207's predominant purpose test to determine whether the Commodity Exchange Act applies to a hybrid product. This test will allow product developers, issuers and purchasers to know with certainty how a product will be regulated.

In contrast, the Bond-Wirth Alternative provides a series of alternative standards that will promote uncertainty, encourage litigation and vitiate the safeguards of the current regulatory regime. The Bond-Wirth Alternative proposes to exclude not only the hybrids excluded under S. 207 but also any instrument whose "predominant characteristics" are not those of a commodity option or futures contract plus those instruments that SEC determines to have the "predominant characteristics of securities" or that derive at least 50 percent of their value from securities plus those instruments listed on a national securities exchange or quoted through NASDAQ. The SEC or any issuer who fills out a securities exchange listing application could simply elect to exclude an instrument from the Commodity Exchange Act and the stringent regulatory standards contained in S. 207.

Perhaps unintentionally, hybrids are not the only instruments that could be excluded from the Commodity Exchange Act under the Bond-Wirth Alternative. The Bond-Wirth Alternative could be read to go even farther than letting the SEC regulate stock index futures as proposed in legislation introduced last year. Any instrument that the SEC determines to have the "predominant characteristics of securities" would be excluded from the Commodity Exchange Act. For example, the SEC has taken the view that a Treasury Bill futures contract is a security. As a result, it is

not difficult to imagine the SEC regulating trading in Treasury Bills and other financial futures under the Bond-Wirth Alternative. Further, the CFTC could do little to stop the SEC from unilaterally excluding Treasury Bill futures from CFTC jurisdiction and the Commodity Exchange Act. The Bond-Wirth alternative allows the CFTC to retain jurisdiction over instruments traded on a futures exchange only if the CFTC determines that the instrument is not excluded under one of the tests listed above. The CFTC could have difficulty making that determination where the SEC has already made a determination to the contrary. This is true because the SEC determination is self-executing; the SEC determination satisfies the test and precludes a CFTC challenge. Clearly, the Bond-Wirth Alternative calls into question the continued viability of the Commodity Exchange Act.

Further, the standards proposed in the Bond-Wirth Alternative are imprecise, increasing the likelihood of litigation. For example, the CFTC and issuers could litigate whether a particular instrument does or does not contain particular "predominant characteristics." The SEC and the futures exchanges could litigate whether the SEC determination that a particular instrument has "predominant characteristics of securities" is correct. These and other issues could keep the lawyers busy in the courts for many years. Meanwhile, the development of innovative hybrid products in the United States would slow, move overseas or cease.

The Commission is also concerned about the approach of the Bond-Wirth Alternative to swaps. The Bond-Wirth Alternative excludes a broad class of swaps from the Commodity Exchange Act rather than providing objective standards, as S. 207 does, under which the Commission is directed to exempt swaps from the Commodity Exchange Act. The effect of the Bond-Wirth Alternative would be to permit futures contracts that are erroneously or fraudulently being labelled swaps to trade off-exchange or on exchanges that are unregulated by the Commission. These futures, a.k.a "swaps," would be exempt from the rigorous audit trail required by S. 207 as well as the Commodity Exchange Act's prohibitions against fraud and manipulation.

Finally, the Commission does not understand the Bond-Wirth Alternative's perceived need to exclude insurance company issues and loans from the Commodity Exchange Act. Why not exclude the sale of automobiles under installment contracts or incentive clauses in professional sports contracts? These contracts too have elements of "futurity." The Bond-Wirth exclusion is unnecessary because the Commission has never asserted that traditional insurance products and loans are futures or options contracts. Unfortunately, this exclusion creates a loophole for fraud by encouraging the creation of off-exchange futures products labeled as "loans." Further, the misplaced reliance on "futurity" inherent in this proposal only draws attention from the proper focus of a

determination of whether the Commodity Exchange Act applies to a particular transaction. In making this determination, both the courts and the CFTC have held that the transaction should be viewed as a whole with a critical eye toward the underlying purpose of the transaction.

The final clause of this section of the Bond-Wirth Alternative also would amend the Commodity Exchange Act to make it inapplicable to loans made in connection with commodities accounts by a broker-dealer registered with the SEC. Because securities broker-dealers are frequently also registered as futures commission merchants, this provision could present an unintentional threat to the safety of commodity customer funds and the soundness of the financial condition of such firms. The provision could also undermine the preferred status of customers over lenders that has been a hallmark of the Commodity Exchange Act for over fifty years, and would discriminate against futures commission merchants that are not registered as securities broker-dealers.

Section 304--Index Participations

The Commission is very concerned that the Bond-Wirth Alternative contains yet another attempt to shift CFTC jurisdiction over stock index futures to the SEC and to eliminate the safeguards of the current regulatory regime. This attempt appears in the guise of a new approach to settling the stock index participation controversy. The Bond-Wirth Alternative uses the term "stock index participation." The definition of this term will be supplied by the SEC. "Stock index participation" could easily be defined to include any stock derivative, including clones of presently trading stock index futures. The Bond-Wirth Alternative further provides that stock index participations are not futures contracts despite an appellate court decision to the contrary. Thus, the SEC could approve stock index futures contracts for trading on securities exchanges or NASDAQ. Neither the Commodity Exchange Act nor CFTC jurisdiction, including the stock index futures provisions of the Shad-Johnson Accord approved by this Committee, could be invoked to prevent or reverse that approval.

Section 305--Directive Regarding Intermarket Issues

This portion of the Bond-Wirth Alternative originally appeared in S. 207 as it was introduced in January 1991. The Agriculture Committee agreed with the Commission that these intermarket directives are duplicative of the coordination and reporting requirements in the Market Reform Act of 1990.

Given the short time available for comment on the Bond-Wirth Alternative, we have only highlighted our major concerns about the proposal in this letter.

Yours truly,

Wendy Gramm

Wendy L. Gramm
Chairman

cc: Senator Patrick Leahy
Senator Richard Lugar

The CHAIRMAN. Very good.

Let me just indicate that Senators Kerry and Gramm were here and had to leave to go to the joint session.

I am going to call briefly on the members who have come in for comments that they want to make in the opening comment category, and then we are going to go right to the witnesses.

Senator Shelby.

Senator SHELBY. Mr. Chairman, I have an opening statement that I would just like to have made part of the record in its entirety, and I would rather go right to the questions.

The CHAIRMAN. Without objection, it is so ordered. I also have a statement from Senator Sanford that without objection shall be inserted in the record.

OPENING STATEMENT OF SENATOR TERRY SANFORD

HEARING ON S. 207, THE FUTURES TRADING PRACTICES ACT OF 1991

APRIL 16, 1991

Thank you, Mr. Chairman, and I would like to join you in welcoming our witnesses and thanking them for making themselves available so quickly this morning to help us address a major issue facing the Congress.

Given the strong opinions that have been expressed by the Securities and Exchange Commission, the Federal Reserve, the CFTC, the banks, the securities firms and the futures exchanges, I think it is imperative that we carefully examine these issues and work to find an acceptable compromise. As we all know, these are complicated issues, complicated financial products and complicated statutes. I believe it would be far preferable to try to work out a compromise that members of this Committee and members of the Agriculture Committee can agree to, rather than trying to work out changes on the floor. I hope that the insights obtained from this hearing will help us do just that.

When we hear strong concerns being expressed by those appearing before us about the implications for the competitiveness of our capital markets, they must be taken

seriously. The debate over how best to regulate products that have some elements of futurity and some elements of a security has raged long enough. We must fashion an approach that supports the development of such new products, without jeopardizing the regulatory system or the consumer protection provided by adequate regulation. I appreciate the work of many of my colleagues and the witnesses who appear before us to do just that.

I believe a good deal of progress has already been made. While the Federal Reserve did not seek it, the agreement to give the Federal Reserve the authority to set margins on futures contracts represents a compromise from many quarters and addresses one of the major concerns expressed in the Brady Commission report following the market crash on 1987. Moreover, the amendment worked about by the CFTC and the leadership of the Agriculture Committee goes a long way toward addressing the concerns over swaps.

With this bill, we have the chance to clear up a few remaining items of concern, including the regulation of hybrid products and the exemptive authority of the CFTC. I hope we can use this opportunity to address these issues. While many would like to see us go much further than that, I hope that at least these remaining issues can be addressed.

Again, I thank our witnesses for being with us and look forward to their testimony.

The CHAIRMAN. Senator Domenici.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Well, Mr. Chairman, because I may not be here for all of the questions, I would like to take about 2 minutes.

First, from my own standpoint, so my ultimate vote will be understood, I am really not interested in the jurisdictional dispute that these two major American institutions have been having. I am glad I was not on any committee that was asked to resolve it heretofore, so I can be very, very neutral.

I am interested in what will give the United States the most internationally competitive market for these new and innovative hybrid securities. I am not interested in a compromise that is worked out by an administration which I support 99.9 percent of the time that is predicated upon nothing other than if you do it the way that we have resolved it in this compromise, it is apt to become law.

I think maybe we ought to decide what is going to become law. I remember my good friend the Secretary, and we understand his feelings, he was for one agency and do away with this problem some time ago. That is my recollection.

Is that not right? I notice his representative is nodding "yes." That is correct? When he did the study, he thought maybe we ought to have one entity doing all of this.

Please?

UNIDENTIFIED SPEAKER. The Fed.

Senator DOMENICI. The Fed recommended it?

UNIDENTIFIED SPEAKER. Treasury recommended it to the Fed. The Fed declined——

Senator DOMENICI. Oh, I have not talked about the Fed yet. I am talking about the Secretary saying this compromise is good, and I am saying he was for something completely different awhile ago.

I think he is just saying this might resolve a very heavy dispute, so why do you not go ahead and resolve it. But, anyway, let me add one more.

I would be interested in knowing what the "predominant purpose" language is really going to mean for this country. I am not interested, where I can do otherwise, in inviting litigation.

All of us have been around, and we have been saying over and over, why do we not write laws that, to the maximum extent, avoid litigation?

I have a red flag when you have securities, hybrids that vary in value on each side of the ledger, and you say "decide the 'predominant purpose'."

I think that could change from week to week, month to month. You could be in the middle of the process and it would change. I know people say, no, but good lawyers will say, yes. So I would hope that we would not have to do that.

Then I would like to know, if not right now, before I vote, I will ask the witnesses to tell me this: Just provide the procedure that a new hybrid would have to go through in the United States under the Ag Committee process, and then what procedure would that hybrid have to follow in London.

Then, what would the procedure be under Bond-Wirth.
I think that would be very interesting.
I thank you very much, Mr. Chairman.
The CHAIRMAN. Thank you, Senator Domenici.
Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you very much, Mr. Chairman.

This issue is far more serious than has been suggested as just a fragmentation issue. I appreciate the fierce defense of the distinguished Senator from Illinois. He does a wonderful job on behalf of his constituents. I have enormous respect for that. But this is not a turf battle.

This is a battle about coordination between markets and regulators and the serious concerns about the stability and liquidity of our markets. That is what we are talking about.

Investor confidence in our markets. That is the fundamental goal we ought to be thinking about. Unfortunately, that fundamental goal has in my opinion gotten eroded by the fact that the regulators have not gotten together. We have not had a coordinated and, to use Secretary Baker's own term, a "rationalized approach" to this regulatory scheme.

I would suggest to you that what is in the Bond-Wirth proposal begins to get at this, as well.

We have in our proposal a requirement for improved coordination. It is a step in the direction that the Secretary has asked us for, both in his previous incarnation and in this incarnation, that it is imperative that we do so. We have to continue to look at the rationalizing of these markets and coordinating them.

The issue is not New York versus Chicago. The issue is not the SEC versus the CFTC. The issue is investor confidence, liquidity, safety and soundness. That is what we are after, and that is why I would urge my colleagues to look very, very carefully at the proposal, and particularly the second part of it that Senator Bond and I have put together.

I thank you very much for having this hearing, as well, Mr. Chairman. It is very important. This issue is far beyond the parochialism that has been suggested in much of the debate surrounding it.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Wirth.

I think everyone can see the intense interest that this issue has created on this committee. Unfortunately, we do have this joint session that is going on at the same time which takes some of our members away who otherwise would be here.

I am going to pose three questions that I want to ask all of you to respond to.

The first two questions I am going to ask you to respond to with a "yes" or a "no." I realize that is difficult in this town when you want to say "yes and no," but I want either a "yes" or a "no."

On the third question, I will give you plenty of time to elaborate with all of the caveats and the fine distinctions that may be necessary as to how you have responded to the first two.

But I want to put these two alternatives up on the table side by side for comparison, what is in S. 207 and what is now called the Wirth-Bond alternative beside it.

I would like to ask you to assess these two in comparative terms as to which is the better in terms of this test:

Which do you think would do the better job of promoting innovation, of fostering competition, and of providing regulatory certainty?

Now let me just say them again: Promoting innovation, fostering competition, and providing regulatory certainty.

And of course this obviously applies to a broad range of financial products that might be brought forward. But from a public policy point of view, I would like to know which of these is better in your mind.

Chairman Greenspan, what would your view be? Would it be—let me put it in the "yes" or "no" form in the sense of would—[Laughter.]

Would the Wirth-Bond alternative be better than S. 207?

Mr. GREENSPAN. Yes, Mr. Chairman.

The CHAIRMAN. Mr. Glauber.

Mr. GLAUBER. Mr. Chairman, I apologize, but I have got to answer that a little more broadly.

The CHAIRMAN. Well, give me the "yes" or "no" first, and then answer it more broadly.

Mr. GLAUBER. Mr. Chairman, it puts us in a position that I cannot answer "yes" or "no." We support the current amended version of S. 207.

The CHAIRMAN. I know you have made that point. I am trying to split it in pieces here so that we can get some kind of a judgment from a policy point of view. I realize you are sort of dug in, having taken that position before in the aggregate.

I am trying to decide here and to draw out of you for the record whether, from the point of view of just these parameters, one is better than the other. And you are not violating anything to give an honest answer and you ought to be able to say "yes" or "no" and then elaborate.

Mr. GLAUBER. Mr. Chairman, from a policy viewpoint, clearly the Bond-Wirth substitute is closer to what the administration originally proposed.

The CHAIRMAN. I take that to be a "yes"? [Laughter.]

Mr. GLAUBER. It is meant to be what it says, Mr. Chairman.

The CHAIRMAN. Well, I realize that you feel like you are in a difficult spot here, but the problem is that you are here as an expert witness and we are really asking for a professional opinion.

I mean, you have got to put everything else aside here. We are asking you which approach, from the point of view of these three tests, is preferable. You might very well endorse the other proposition for 10 other reasons, but on these points I think we have to have a clear-cut professional judgment from you.

Mr. GLAUBER. On these policy issues, the substitute comes closer to what we originally proposed, and obviously we would feel more comfortable with it on a policy basis.

The CHAIRMAN. All right. I take that as a "yes."

Mr. Breeden.

Mr. BREEDEN. Yes.

The CHAIRMAN. Ms. Gramm.

Dr. GRAMM. No.

The CHAIRMAN. Let me ask you now in a slightly different vein the same type of question with respect to which would promote greater innovation and competition.

This is more the issue of what the future might look like and how do we foster both innovation and competition, which I think in and of themselves are useful.

So let me pose the question in the same way.

Would the Wirth-Bond alternative be preferable to what is in S. 207, Chairman Greenspan?

Mr. GREENSPAN. Yes.

The CHAIRMAN. Mr. Glauber.

Mr. GLAUBER. On a policy basis again, I would make the same statement that I did before.

The CHAIRMAN. I take that to be a "yes."

Mr. Breeden.

Mr. BREEDEN. Yes.

The CHAIRMAN. Ms. Gramm.

Dr. GRAMM. No.

The CHAIRMAN. Now let me give each of you a chance, to the extent you want to take the time to do it, to elaborate as to why you feel that way.

I do not like to be that arbitrary on answers, but I think we have got to know where we are, and I think we now know where we are.

Do you wish to make any clarifying comment or elaboration, Chairman Greenspan?

Mr. GREENSPAN. Well, Mr. Chairman, just let me repeat the essence of what I offered in my testimony. The basic question here is really down to the issue of exemption or exclusion. I have no question that in the vast, vast majority of cases the current CFTC, especially the Chairperson, would come out in the way which I would think would be promotive of a viable, competitive, innovative system. But we are talking about law. We are not talking about the issue of particular regulatory actions.

In this respect, I would very strongly argue that there are certain areas which an exclusion rather than an exemption will eliminate a degree of uncertainty which of necessity must overhang the world financial scene because an exemption that has been made is an exemption that can be reversed.

An exclusion is a permanent action which creates certainty with respect to the issue of the construction of various different types of products and, of necessity, would therefore enhance the innovative nature of such products.

The CHAIRMAN. Mr. Glauber.

Mr. GLAUBER. Thank you, Mr. Chairman.

Let me just emphasize that either the current proposed version of title III or the substitute proposed by Senator Bond and Senator Wirth I think takes a great step forward in the harmonization of margins by providing for Federal oversight of stock index futures margins, and I would very much hope we do not sacrifice that in anything we do.

We have——

The CHAIRMAN. Let me just say, there is no intention to do that. I know of no quarrel over the margin issue.

Mr. GLAUBER. I understand that, but I want to emphasize the fact that previous attempts to go beyond what is contained in S. 207's title III resulted in stalemate and made it impossible to take this important step forward on margins for stock index futures. We view the exclusivity provision of title III as a modest step forward, and one that moves in the right direction, although not as far as the administration tried.

I would encourage this committee to make certain that we take the important step forward on the margins issue, and not sacrifice that and return us to stalemate.

The CHAIRMAN. Mr. Breeden.

Mr. BREEDEN. I would agree with Chairman Greenspan's characterization of the difference between an "exemption" and an "exclusion." To subject every new product to a bureaucratic proceeding, even assuming that the agency—and I do assume that the CFTC like the SEC would take that responsibility seriously and would attempt to move expeditiously—but nonetheless, there is a vast difference between saying that if a product is thoroughly regulated under a banking regulator, or thoroughly regulated under the Nation's securities laws, then it does not need to go over and have this additional new regulatory proceeding over at the CFTC versus the approach contained in S. 207 that says we will do both.

We will get approvals in many cases under banking law or under securities law, and then we will deal with whether there will be a veto arising out of this exclusivity provision. That is a level of duplicate activity that seems to be unnecessary.

It also creates, Mr. Chairman, uncertainty because there is no exclusivity clause in London. There is no exclusivity clause in Switzerland. There is no exclusivity principle in Japan. So the developer of a product that is a hybrid, that is not black or white, but is somewhere in the gray zone, can say well I can take my chances that I am sued—not by the CFTC but by a private party claiming that my product does not meet the 51-49 test.

I can go to the expense of defending myself in the U.S. market, or—as many of the examples I indicated prove—I can just move the product offshore.

The approach of Bond-Wirth avoids that risk because it says the developer of a product, if it fits within securities law, or within banking law, or within the Commodity Exchange Act, has a free right to bring that product on a futures exchange, a stock exchange, or in a banking environment. And that I think would be the simplest approach and would promote the greatest innovation and provide absolute certainty as to the legality of those products.

The CHAIRMAN. It sounds to me as if the market would decide. When all else fails, it is not a bad principle.

Dr. Gramm.

Dr. GRAMM. Yes. I would like to take each of your points separately.

With respect to innovation, let me just point out that most of the innovation in the financial markets have occurred on the derivative market side. By "derivative market side" I am referring to things that the CFTC regulates.

You should also know that many of those instruments, including the invention of financial futures in the first place, were introduced here in the United States and they are being copied around the world.

So I do not think you can say that innovation that is going to be stifled.

But the issue here is not whether or not we are going to stifle innovation. New products will be developed. What we are talking about right now in this bill is: Under what regulatory regime, under what customer protections, would these products be sold?

You in Congress have determined that—and it is true—that futures are different from securities; securities are different from futures, and the functional regulatory regime that says that they will be treated differently recognizes that. With respect to the 50-percent test, we are providing certainty here as to what regulatory regime and what customer protections will be available.

With respect to fostering competition, let me just say that the way I characterize Bond-Wirth is that under the Wirth-Bond bill that if it is a futures, it can be traded as a security if the SEC says so. If it is a security, it cannot be traded as a futures because there is no opening the door the other way.

Furthermore, if it is a currently trading future, it cannot even be a future if the SEC says otherwise. That is not competition to me by any stretch of the imagination.

With respect to, again, regulatory certainty that you asked about, the 50-percent test that we have proposed would be self-executing, let me say that it is a simple test. We already have experience with it, as Chairman Greenspan mentioned. Over 2 years ago the Commission proposed a rulemaking for options that proposed a 40-percent test with some other safeguards.

Under this proposal, we would eliminate all those other requirements and we would move the 40 percent up to 50 percent. People would not have to come to the CFTC. We would simply do a rulemaking which would be very quick—and I provided examples—how this test would work. It is a simple arithmetical formula. The financial engineers have not had a great deal of trouble working with our hybrid test, the 40-percent test, over the past 2 years.

They have to do these things in pricing their products all the time. So it is not a difficult test, once that formula is out there, and we have put the formula in the statute. But once it is implemented, they do not have to come to us at all. It would be self-executing just as our hybrid rules are self-executing at this point in time.

I would also like to discuss the Gold Link Bonds that were mentioned. Two years ago the Commission also wrote a statutory interpret that said that—I call it the "blank denominated bond, or CD." If it is a bond or a CD that is linked or tied to the price of gold, or yen, or any other commodity price, then it would not fall under the Commodity Exchange Act.

That was done over 2 years ago. I would say that many of these products are being sold overseas for tax purposes and also, very frankly from what I understand, to be out from under other regulatory requirements such as SEC registration. So it is not true that the offer of those products has been totally stifled over here.

So in summary, I would say that the Bond-Wirth proposal would foster a lot of uncertainty and litigation over its words, and it would also not be at all competitive in the sense of what would be allowed to trade. It would simply create a huge amount of chaos and confusion.

The CHAIRMAN. Thank you.

I am going to now try to accommodate all of the members and move along and try to stay within our time limits, as best we can.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Let me first of all say that I think Senator Wirth has outlined this situation as well as it can be, on what we ought to be considering here today.

Unfortunately, after 17 years on this committee, I see another turf battle.

It is distasteful to me that we're not looking at what Senator Wirth said we ought to be looking at.

Two years ago, I wrote a letter to both the SEC and the CFTC, before or when the SEC was first prepared to authorize trading in Index Participations, and I asked that they resolve this.

I didn't think that was too much to ask of one administration with people working for the same administration to do that.

So, although I'm pleased that the committee is holding this hearing today, I'm sorry that it's necessary.

We get involved in too many turf battles.

There's one here in Congress.

And while I don't like them, this has been an ongoing battle, not on this but on other issues, between the Senate Agriculture Committee and Banking Committee.

One of the reasons I feel strongly about this matter, is that when we get into bank powers and bank products issues, we hire staff on this committee who have expertise in those areas.

I don't know that the Agriculture Committee does.

I don't know that we should, yes, I know we should not, as a matter of fact, be involved in agricultural issues.

We don't have staff on this committee for that purpose.

And on many other issues over the years, the Agriculture Committee has stuck their nose into things over turf where they simply do not belong—it's not they don't have good people—but their background and experience isn't in that area.

So, again, although I'm pleased we're having this hearing, I guess I'm sorry that it is necessary, and this couldn't be resolved a long time ago.

As I listen to the answers, it's obvious that the administration wanted it settled.

Mr. Glauber hated to say yes or no, and I can understand why; the administration made a deal. That doesn't make it a good deal.

And I think it's unfortunate, again, that we are here.

Chairman Greenspan, in your testimony, you note that S. 207 suggests the CFTC would have some jurisdiction over depository instruments and lending transactions.

I've heard the same concern expressed by Bill Seidman, by the Comptroller of the Currency and the banking industry.

Do you believe that the CFTC should have jurisdiction over depository instruments or lending transactions?

Chairman GREENSPAN. I do not, Senator.

Senator GARN. Mr. Glauber——

Chairman GREENSPAN. I think there is sufficient regulatory oversight of these instruments as they interrelate with various other elements in the banking and financial system and do not see the need for additional regulatory authorities to be imposed on those already in existence.

Senator GARN. Mr. Glauber, do you believe that the CFTC should have jurisdiction over depository instruments or lending transactions?

Mr. GLAUBER. In general, no. And, Senator Garn, this part of title III, of course, would only affect those small number of depository instruments that might not pass the 50-percent test, and it would mandate that the CFTC exempt them when subject to bank regulatory oversight.

Senator GARN. Well, I understand.

But we get back into, and I agree completely with Chairman Greenspan about exemption versus exclusion.

We can play that game until I don't have any hair left, on who gets an exemption or not. [Laughter.]

Mr. Breeden.

Mr. BREEDEN. Senator, I agree with Chairman Greenspan fully, though I think that the same principle should be applicable not just to instruments that are under banking regulation, but also instruments that may be offered by regulated insurance entities or by a securities exchange.

When you have a product that's listed on the New York Stock Exchange, and is subject, A to Z, to the full panoply of protection for investors and market stability that is contained in the securities laws, we don't see any offsetting harm in allowing that product to simply trade under those laws, and give it an exclusion.

Senator GARN. Ms. Gramm.

Dr. GRAMM. I don't disagree.

But I want to point out that in the Wirth-Bond proposal, there are no definitions.

So somebody could say, are you a loan, and somebody would say, yes, I'm a loan. That label could be put on it, even though it could be a futures.

If they are true loans or true deposits, then we would exempt them. With regard to loans—we don't claim to regulate loans.

The question is whether someone can sell a futures and have a boiler room futures exchange, an unregulated exchange, and put any kind of label on it?

Could someone call it a swap, call it an IP, or call it something else, and then evade regulation?

Senator GARN. Well, I don't think it evades regulation.

And, in general, you agree with me that bank products shouldn't be covered by the CEA?

Dr. GRAMM. Real bank products should not be.

Senator GARN. Why can't we just simply exclude them, rather than playing the exemption game, then?

Dr. GRAMM. Real bank products, I have no problems with.

And as I said——

Senator GARN. Well, we can argue about real bank products.

We can argue about real agricultural products, too.

Let me ask all of you, because my time is up, if any of you think, and I said in my opening statement, I do not, and I'll start with Chairman Greenspan, that title III affects farmers?

Does title III affect farmers?

Chairman GREENSPAN. It shouldn't.

Senator GARN. Mr. Glauber.

Mr. GLAUBER. I don't believe it does, no.

Senator GARN. Mr. Breeden.

Mr. BREEDEN. No, sir.

Dr. GRAMM. I think that you can ask the Ag community, and they feel very strongly about the CFTC's reauthorization, as well as the compromise.

Senator GARN. No.

I agree, Wendy, that they're very interested in CFTC reauthorization, as am I.

That's title I and title II.

I simply want to repeat, I don't think title III affects farmers in any way whatsoever, and that's where I think the Ag Committee is sticking their nose into something they know nothing about.

That's all we're debating here today, and the only thing that I feel strongly about is title III, as far as jurisdiction and what we are doing.

Title I and title II, let's pass it.

But I think it's very important that we settle title III in a much better way than the compromise worked out by the administration, which I don't think is satisfactory.

Dr. GRAMM. If you'll excuse me, the Wirth-Bond proposal alternative to title III would allow the SEC to declare any of the Ag futures as a security, and the Commodity Exchange Act would not apply.

Senator GARN. Well, I haven't expressed my opinion on Wirth-Bond here yet today. I'm only talking about the compromise in title III that I do not agree with and which the administration had not.

My time is up.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, I hope that the committee has not lost sight of why we're here this last time today.

Over 3½ years ago, in October 1987, there was a stock market crash.

This committee started holding hearings, and we had the Brady Commission Report that made certain recommendations, that were basically four: circuit breakers, intermarket communications, large trader reporting requirements, and margin requirements.

We did three of them. They came out of this committee. I voted for all of them, and I supported them, as did everybody on this committee.

The only thing left is the margin requirements.

It's been over 3½ years since that crash.

CFTC has been without authorization, now, for 16 months.

The exclusivity issue that this hearing today is all about, IP's, hybrids, swaps and other things has absolutely nothing to do at all with the issue, nothing.

It's a turf battle, pure and simple, just as it was from day one, and has nothing to do with the stock market crash.

Now, Mr. Glauber from Treasury made a statement on page 13 of his testimony that I'd like to quote back to the committee.

> Let's not make the best legislation the enemy of good legislation. If we wait for a perfect bill, we may be waiting a long time.

Now, I ask every member of this panel, is this an improvement over existing law, this bill, S. 207?

Whether you like all of it, or not, is it an improvement over existing law, yes or no?

Mr. Chairman.

Chairman GREENSPAN. No. I think that strictly speaking, on its merits, S. 207 is a marginal improvement over existing law. My concern is that it is not a significant enough improvement to really make a change.

Senator DIXON. Mr. Glauber.

Mr. GLAUBER. I believe on the margins issue it is a significant improvement and much to be sought. On the issue of exclusivity, I think it is a modest improvement, as we have said.

Senator DIXON. Mr. Breeden.

Mr. BREEDEN. As I said earlier, I think in some areas, the bill makes modest improvements; in other areas, it is probably a step backward.

And on the whole, the exclusivity issues, it's a tragic failure to solve this issue in a forum that puts it aside for the future, rather than stopping at any moment in time.

Senator DIXON. Well, it doesn't please you but is an improvement over what the House has done?

They did nothing.

Mr. BREEDEN. As to the exclusivity issue, depending on the final language, the version that came out of the Agriculture Committee, prior to the suggested manager's amendments, and I realize that the committee product was developed very late, some of it in the night before the markup and hasn't had a chance to be carefully considered, but unquestionably the committee version would have done substantial damage to the swaps market, and to many securities markets, and would have been a major step backward.

And in that sense, the House bill, doing nothing, would have been preferable to the Agriculture Committee version of the act.

Senator DIXON. Well, Mr. Breeden, I think the remarkable position some take in connection with this compromise is, if it's not their bill, it's not a satisfactory bill at all.

This Senator, in his legislative career which now spans 31 years, has voted for thousands of things he didn't think were perfect, and that didn't please him a 100 percent.

Mr. BREEDEN. Senator, if I could make just one quick response to that.

I think you're absolutely right.

And this Chairman of the SEC, although I didn't think the compromise that was developed by the Banking and Agriculture Com-

mittees, though I didn't think that compromise was perfect, I was the first person at this table to endorse it, and we spent about 6 months working with the two committee staffs to try and perfect it.

So I agree with you wholeheartedly that we need to try to meet the public interest in strong and safe futures markets and securities markets, and to try to get the lawyers on the sidelines and let the markets do their work at making this a competitive country with a strong financial system.

Senator DIXON. Madame Chairman.

Dr. GRAMM. I believe this is an improvement over the current law.

But, as you know, I don't particularly love all parts of the proposal, as well, but it is an improvement.

Senator DIXON. Now, may I ask the panel, does anybody here think, now that we've spent this morning on S. 207, that anything in this bill subtracts, in any way, from the jurisdiction of the Banking Committee?

Takes anything away from the Banking Committee's jurisdiction? [No response.]

Does anybody think that? [No response.]

That's the grounds, you see, for our being here this morning, is that sometime, somehow, in this process, we have somehow imposed on the jurisdiction of this committee.

Dr. GRAMM. You are getting jurisdiction.

Senator DIXON. We are gaining jurisdiction, are we not?

Dr. GRAMM. Yes.

Senator DIXON. CFTC is losing jurisdiction, is it not?

Dr. GRAMM. Yes.

The CHAIRMAN. Anybody else have an answer to Senator Dixon, or not? [Laughter.]

Mr. BREEDEN. I would hesitate to express an opinion, having gone through enough pain and suffering over dealing with jurisdiction of agencies, to get involved in dealing with the jurisdiction of congressional committees.

That's why I'm a little slow to respond to the question.

I would say that, to the extent, in the colloquy we were having a moment ago, that the issue comes down to what is a real banking product, to use Senator Gramm's words, and what isn't a real banking product, if, as a result of title III, it is the CFTC that is making the judgment in their rulemaking petitions, what is a real banking product and what isn't, instead of the FDIC and the Federal Reserve, then those agencies and this committee have quite definitely lost jurisdiction.

Senator DIXON. Would you not concede that under that exclusivity rule, that those things that are found to be securities under that rule, thus would be part of the jurisdiction of this committee and part of the jurisdiction of the SEC?

Mr. BREEDEN. No.

What this bill is doing is to reduce the administrative assertions of the sweep of exclusivity that have been made in the past.

For almost 60 years, since the passage of the Securities Act of 1933 and the Securities and Exchange Act of 1934, it was the business of the SEC to interpret what in fact was a security.

And we won some cases in that area and we've lost some cases in that area, but that was the responsibility of the Securities and Exchange Commission, in the same way it's the responsibility of the FDIC and the Fed to interpret what's a deposit or a loan.

It is possible at some times for the SEC to think something like a money market fund is a security, when a bank regulator might think it's a deposit.

But they don't have the ability to reach out and block it.

The so-called IP's decision we've been discussing, and where title III and its 50-percent test comes out, is a result that things that we may believe are appropriate to be traded on the New York Stock Exchange are subject to a veto right arising under the Commodity Exchange Act.

And we don't think that veto right is necessary.

Senator DIXON. Well, I find your point of view, Mr. Breeden, extraordinarily unusual in the sense that you treat a situation in which instruments are clearly going to be brought under your jurisdiction as one in which there has been no accommodation of the disparate points of view, and I say, as far as that is concerned and the attitude of this committee with respect to jurisdiction, it absolutely flies in the face of the facts and the past accord in 1982.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Mr. Chairman, I'm struck by this exclusivity. issue. We had a question a minute ago, asked by Senator Garn, about exclusivity. Should the SEC, should the CFTC be able to regulate bank deposits and lending transactions?

The Chairman of the Fed said, no. And he was for exclusivity in bank regulation. He thought banks ought to be regulated by people involved in the bank regulation business.

Why not let banks choose? Why not let them opt to be regulated by whoever they want to be regulated by?

That is not a principle that we have ever followed in the regulatory history of this Nation, except to some extent, we followed it under the S&L's.

I wonder what would be the result if we went back to 1982 and we asked the same question that the chairman asked: to promote competition, regulatory certainty and innovation, was the regulation of the S&L's from 1982 until last year, optimum? The answer is, yes.

The point is, however, there are other things besides competition, regulatory certainty and innovation.

Nobody asked a question about safety and soundness.

The bottom line is that the Bond-Wirth bill or the Wirth-Bond bill is a totally one-sided bill that lets instruments opt to be securities, but it doesn't let securities opt to be futures.

It simply moves things in one direction.

Let's say that stock index futures didn't yet exist. Say that the Bond-Wirth bill were adopted. Say the SEC claimed jurisdiction over the proposed new instrument, namely stock index futures.

Now, let's say the SEC said, don't trade it, don't trade it. It serves no useful purpose, as they actually said back in 1978.

I find it almost obscene that a regulatory agency which has been an agency that has impeded innovation is now telling an agency

that has been the very fountain of innovation, that somehow not giving them more power tends to limit innovation.

It borders on the obscene.

But let me ask the question.

If stock index futures did not exist, if we adopted the Bond-Wirth bill, if the SEC claimed jurisdiction and was given jurisdiction, and then decided stock index futures had limited utility and no demonstrated economic purpose, would that promote innovation?

Let me ask Chairman Greenspan to respond first.

Chairman GREENSPAN. That's a question I think you ought to address to——

Senator GRAMM. No. I thought about it, but I decided to address it to you. [Laughter.]

Chairman GREENSPAN. Well, you're asking me a hypothetical question that a certain event would occur, which I'm not certain would occur, and which I presume would not.

The issue here is essentially a question of which particular model of regulation would best serve innovation, safety and soundness, and all the various other elements that we're discussing. The truth of the matter is, every single model of regulation has both positive and negative aspects to it. And the question really isn't so much an issue of individuals choosing whom their regulator is going to be, because, in fact, we do have such a situation. Obviously, within the banking community, an individual bank can make a decision as to whether or not it's regulated by the Federal Reserve or if it's a State-chartered institution, it can make a judgment about whether or not it wishes to be a member or nonmember.

I don't consider that that is the crucial question. I consider the issue of endeavoring to make regulation as simple and straightforward as possible, so as not to block the innovative characteristics of a number of products, which almost surely will emerge in the years ahead, as technology enables the issue of risk reduction and dispersion to take place in an evermore complex way.

Senator GRAMM. Mr. Glauber, let me ask you the question.

If the Bond-Wirth bill were adopted, and if the SEC claimed jurisdiction, if stock index futures did not exist, but were a new hybrid product coming on the market, and if the SEC determined, as they did in 1978, that they had limited utility and no demonstrated economic purpose, would that promote competition? Would that promote world competitiveness?

Mr. GLAUBER. Well, Senator Gramm, I think that is indeed a hypothetical that I just find hard to believe in the current setting.

Senator GRAMM. Well, under the proposal, it's possible is it not?

Mr. GLAUBER. Anything is——

Mr. BREEDEN. No. Absolutely not.

Senator, the hypothetical is just completely at variance with what the provisions of the bill provide.

Under the bill, as submitted by Senators Wirth and Bond, if the CFTC were to find this new hybrid instrument fell within the Commodity Exchange Act, it met all the normal criteria for listing on a futures exchange, it could so list it on the Chicago Board of Trade or the Chicago Mercantile Exchange or the Kansas City Board of Trade.

And nothing the SEC said or did could affect that in the slightest.

Now that is what the law provides.

What it also provides is that if a similar instrument was, in the opinion of the SEC, a security, that we could license a similar instrument to an instrument that was on the Chicago Mercantile Exchange to be on the New York Stock Exchange.

And, God forbid, the New York Stock Exchange and the Merc might have to compete with instruments that were similar.

But the entire approach of that amendment, and it's unfair to create a hypothetical that just simply isn't accurate, the entire approach of that amendment says that the developer of the product asks the CFTC to license it, and, if the CFTC licenses it, it can go on a futures exchange, and the developer asks the SEC to license it, and if the SEC licenses it, it can go on a securities exchange.

Senator GRAMM. Chairman Gramm, let me ask you to respond.

Ms. GRAMM. That's incorrect.

First of all, let me just state that the letter that Senator Gramm is quoting from is not a hypothetical. That's actually a letter that was sent to the CFTC back in 1978.

And let me point out that, in hindsight, it turned out to be wrong.

The CFTC did have the foresight to say that these are futures and they should trade and they are valuable.

Sometimes it's very difficult, at the outset, to say what is useful and what is not.

The SEC did take that position in 1978.

Let me also point out that what the Bond-Wirth bill does is to say "notwithstanding any other provision of the law, nothing in this Act shall be deemed to govern or be applicable to any transaction if * * * et cetera."

What that means is that the Commodity Exchange Act would not apply if the SEC determines that a product is a security.

Senator GRAMM. So what you're saying, Chairman Gramm, is that, as you read this bill, as your lawyers read this bill, if there were no stock index futures, and if they were proposed to be sold on the market, and if the SEC assumed jurisdiction, under the Wirth-Bond proposal, thereby preempting the Commodity Exchange Act, that then the SEC would have jurisdiction.

Is that right?

Dr. GRAMM. Yes.

Senator GRAMM. OK.

And if they then decided not to let stock index futures trade, what would happen?

Dr. GRAMM. They wouldn't trade.

Mr. BREEDEN. Well, Senator, I would offer to let the committee staff write a very clear provision in any words you want to write, that provides for a new hybrid instrument in exactly the circumstances you are suggesting, that, for a new hybrid instrument, the SEC would have no power whatsoever to block it from being traded on a futures exchange, and that the CFTC would have no power whatsoever to block it from being traded on a securities exchange.

I'd be very happy to agree to any set of words you want to write.

In fact, the words that are in there, with all due respect to my colleague, already say that, but we'd be very happy to amplify it, reamplify it, and make it very, unequivocally clear.

The CHAIRMAN. Senator Wirth.

Senator WIRTH. Thank you very much, Mr. Chairman.

It was my intent, and I believe is shared by the distinguished Senator from Missouri, that if an instrument is brought up before the SEC, and the SEC makes a determination that it's a security, and that instrument is brought up before the CFTC, and they determine that it's a future, then the individual bringing that up can determine where it would go.

That obviates, it seems to me, the argument attempted to be made by the distinguished Senator from Texas in doing this.

In addition, if you look at what the SEC has done, as I understand it, on rule 144, in providing a very clear mechanism for expanding a variety of innovative products, your own record would suggest that that is not a problem.

But leaving that aside, having looked at that provision, and being one of the authors of it, I just wanted to try to clarify that.

Let me ask you all, we keep hearing, and we go back to this, it seems to me, the debate that's been raised about this being a jurisdictional squabble.

Do you think, Mr. Greenspan, that all this is is a jurisdictional squabble between the SEC and the CFTC?

Chairman GREENSPAN. Certain aspects of it, yes. [Laughter.]

The CHAIRMAN. That's what I call an honest man.

Senator WIRTH. Is that all?

Is that all that's at stake here?

Chairman GREENSPAN. No, it is not.

Senator WIRTH. It is not all that's at stake here?

Chairman GREENSPAN. It is not all. I think it's unfortunately like many other things around here, it's a hybrid. [Laughter.]

I certainly subscribe to your opening remarks. When we sweep aside the issues that are turf related, there is a fundamental question here, and it does relate to the issue, as you pointed out, that we're dealing with a major regulatory principle which is essentially directed at future types of financial products, the main function of which is going to be to disperse risk, lower the cost of capital, and improve the functioning of the system.

And in that respect, I would doubt very much if we would have had as an elaborate a discussion and debate on this issue as has occurred, nor would I expect, as many of this committee who have shown up today would have shown up, because it's a principle which goes beyond the simple question of who has the principal regulatory authority.

Senator WIRTH. Can you summarize what that principle is, Alan?

Chairman GREENSPAN. The regulatory principle?

Senator WIRTH. What is the principle that underlies this squabble?

Chairman GREENSPAN. That has to be, obviously, an inference, because there are a lot of elements involved in it.

Senator WIRTH. You just said it, that's why—I'm using your words and playing it back.

Chairman GREENSPAN. What I can say is what I interpret it to be, and it's basically the principle which focuses on the structuring of regulation in a manner which maximizes the capability of effective financial products being brought forth in a manner which will most usefully reduce risk and lower the cost of capital in this country.

Senator WIRTH. Mr. Glauber, could you answer my question about this being, is this more than a jurisdictional squabble?

And if so, what's at stake?

Mr. GLAUBER. I think there are elements of this that go beyond any jurisdictional squabble, although there clearly are elements that can be characterized that way. There are elements, as you suggested in your opening statement, which go to the issue of investor confidence. And I think one of the most important elements is the question of margins, as we've said. And, as we've said, going back to 19——

Senator WIRTH. Everybody agrees with that, there's no question.

Mr. GLAUBER. I understand, Senator Wirth, that everybody agrees with that. But while everybody agrees with it, it's been impossible for 3 years to move forward legislation in Congress dealing with margins. And we consider that to be very important.

The prospect of a return to that stalemate is, for us, something that we do not want to envision.

Therefore, I would agree with you that there are elements here of investor confidence. I think probably the most important element bearing on investor confidence is margins. And I would encourage that we do nothing to undermine an agreement which will let us get this margin issue behind us.

If I might just take this moment——

Senator WIRTH. We're not debating that issue, though, as you know, Mr. Glauber, and we're on really title III of this bill.

Mr. GLAUBER. That's in title III, Senator Wirth.

Senator WIRTH. We're not debating the marginal part of this at all.

There is agreement on that.

That's going to happen no matter what bill gets decided upon on the floor of the U.S. Senate.

No matter which one, the margins are going to be part of it.

Mr. GLAUBER. I understand that, or at least I've been given to understand that. I hope we do nothing that undermines the possibility of the margin provision being finally part of what becomes law.

Senator WIRTH. Well, it's nobody's intent of doing that, certainly.

Mr. Breeden.

Could you answer my question, again.

From your perspective, is this more than a jurisdictional war?

And if so, what principle underlies this, or what principles underlie this.

Mr. BREEDEN. Judging from the number of shells that fly over, there is some element, as Alan suggests, of a war to it.

I think there are fundamental issues of the competitiveness of the securities markets, and I believe also of the banking system, at stake here.

It is important to recognize that though there've been some vague suggestions that there would somehow be threats to safety and soundness, I don't know that anyone has suggested, seriously, certainly no one outside of this room has seriously suggested, that the Bond-Wirth alternative would hurt safety and soundness. In allowing an innovative new product, the Bond-Wirth alternative says that if it's in that middle zone, it's not in the pure securities pigeonhole and it's not in the pure futures pigeonhole, but it's a mixture of both, to let the people who develop the product decide, we want it on the Chicago Mercantile Exchange or we want it on the New York Stock Exchange, and whatever they decide, let it be in that place, under the respective laws.

If it goes on the Chicago Mercantile Exchange, it should be under the Commodity Exchange Act, and if it goes on the New York Stock Exchange, it should be under the Securities Exchange Act.

That would allow people developing new products to not be subjected to the hazard of years and years of litigation in the courts, trying to prove that their new product is 51–49 a security, instead of 49–51 a commodity, and to have that slight difference determine that a product that was once lawful becomes unlawful.

Or, even worse, that a product that an investment banking firm develops this week, and offers at a given spread of interest rates and commodity prices that satisfies the test, it's 55–45 and so it's a security one week, and if another client wants to offer the identical product 3 weeks later, because the commodity price has moved somewhat, it's suddenly 45–55, and it's suddenly unlawful.

Why do we need to subject products that play a role in both capital raising and risk shifting to this duel by combat in the courthouse?

Why don't we let them do the combat where they ought to be, out in the marketplace, in both cases, without restriction and, in both cases, under a thoroughly professional set of laws in the futures exchanges or in the securities exchanges?

Senator WIRTH. Ms. Gramm, do you have any comment on my question?

Dr. GRAMM. I do.

I think there are elements of a jurisdictional squabble.

Every time the CFTC has come up for reauthorization, there has been this kind of a squabble.

Back in 1982, the Shad-Johnson accord divided up responsibility and avoided the squabble by saying that stock index futures would be regulated by the CFTC, while stock index options would go to the SEC.

But that lasted only through one SEC Chairman, that is Shad, the person who wrote it. Every SEC Chairman after Shad has wanted to get back stock index futures, even though they opposed the CFTC approving stock index futures in the first place.

I do believe there is a broader underlying principle that you're arguing right here in the alternative that you have proposed, Senator Wirth.

You're really talking about the regulatory regime under which futures and options will be regulated.

Futures are different than securities.

Securities are different than futures.

Securities are assets.

Futures are merely obligations and are not assets.

Futures are obligations for future delivery.

So what you're talking about here is a regime which you, in Congress, have established, and that has worked well over the past 70 years or so.

That regime is a functional regulatory regime and recognizes that securities, indeed, are different from futures.

Now, in the hybrid area and the 50-percent test, the reason why we're proposing that test is that there are some products, hybrids, that have components of both securities and futures or options.

And we have dealt with some of these.

We've seen innovation in that area.

And the question arises not when these instruments are 90 percent security and 10 percent option.

The question is what happens toward the middle.

And so what we're proposing is a test that would provide regulatory certainty under this majority, the major component test.

It does provide certainty and it does provide a bright line there, and would indeed allow people to develop instruments that combine significant portions of each, securities and futures.

But the underlying issue is under what regime will these instruments be regulated?

And I would submit that you should not just throw away 70 years' worth of successful customer protection and market integrity, as well as financial integrity in these markets, just overnight.

What we have here in S. 207 is a prudent approach to giving the CFTC more exemptive authority and more regulatory flexibility in approving innovative products. Indeed, it does begin to eliminate the exclusivity that all of you have talked about.

It's a very prudent approach. It is a very large step since for the first time in 70 years these changes are being proposed.

And I think that this approach is far superior to just throwing everything away.

Senator WIRTH. Thank you, Mr. Chairman.

If anything, I think we've learned we may have some clarifications necessary on what happens with that in the 49–51 percent zone.

And I think that's come up in the question raised by Senator Gramm and the recent comments by both Ms. Gramm and Mr. Breeden.

We might want to look at that in terms of our language, Senator Bond.

It seems to me that there's been some misunderstanding, and maybe clarifying that will solve people's problems.

The CHAIRMAN. Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

To review the bidding as to how we got to this place, we started out last year and worked hard to come together on a compromise.

The Treasury Secretary indicated the importance, he thought, in bringing regulatory authority at the Federal level over margins.

We also knew at the time there was a major problem with financial products being driven offshore.

So as part of the proposal which we worked out, we dealt with margins; we dealt with hybrids; and exemptive authority.

Now something happened to that proposal which was introduced by Senator Leahy and the other four of us who worked on the compromise.

Somewhere on February 19, 1991, that compromise got hijacked.

What came out was something very different than what went in.

Just to be clear that we know where we are and that the comments are relevant, I would ask any of the panelists: Other than swap language, are there any material or significant changes in the April 9 technical and conforming changes dealing with exemptive authority, hybrid products, index participation, and bank products?

Outside of that, other than the swap language, are there any significant substantive changes?

Dr. GRAMM. No, there have not been.

Senator BOND. Mr. Breeden, is that your view as well?

Mr. BREEDEN. The April 9 version of which?

Dr. GRAMM. April 9.

Senator BOND. The CFTC conforming language——

Dr. GRAMM. Yes.

Senator BOND [continuing]. Submitted to the Ag Committee.

Mr. BREEDEN. Senator, I would not know.

We get these drafts after they have been marked up, and I would not—not that I am aware of.

Senator BOND. All right.

For the purposes of this consideration, then, we would say that comments made prior to April 9 about the Ag Committee version, with the exception of swaps, are still relevant today?

Is that fair?

Mr. BREEDEN. Yes.

Dr. GRAMM. No.

Senator BOND. I mean, has anything changed, other than swaps since April 9?

Dr. GRAMM. We have changed every section except for margin and IP's.

Senator BOND. But there were significant——

Dr. GRAMM. There were changes in the exemptive section, as well as the 50-percent test. And there were clarifying technical changes.

Senator BOND. But they were not significant? They were technical changes?

Dr. GRAMM. They were technical changes.

Senator BOND. One of the things that Senator Wirth has pointed out is that if we have identified some areas of confusion, this may be an opportunity for the agencies and the panel before us to get together and make sure there is no confusion.

I do not see this as a turf battle between regulators, solely.

I think it is a battle between whether these products trade in the United States or overseas.

Some of these instruments that have been driven overseas might not be subject to SEC regulation.

I do not care whether they are or not, so long as they are subject to the basic laws of this country—antifraud laws, contract laws, and other matters.

It was our intent in providing this draft to assure that if the CFTC had an instrument presented to it that it felt was a future, it could trade it as a future.

At page 4 it says:

> Not withstanding paragraph (1), this Act shall apply to and the Commission shall have jurisdiction with respect to any instrument traded on a designated contract market that the Commission determines does not meet the requirements for exclusion under paragraph (1).

If that is not drafted to provide the jump ball that any futures contract that you wish to trade, that wishes to be traded on a contract exchange cannot be traded, please give us the appropriate language.

Do you have concern?

Dr. GRAMM. All we would be allowed to do under that particular clause, Senator Bond, is to determine that indeed the SEC did determine that this say Ag futures product was a security.

Senator BOND. I certainly—you read that very differently than I do.

Dr. GRAMM. And that is what it would be.

Senator BOND. But I would suggest that if the lawyers get together, if there is a better way to draft that so that any product that is set up as a futures contract and provides for variation margins, and clearing functions, can trade on a CFTC regulated exchange, I would appreciate receiving that.

Frankly, we have a situation where we have stock index futures that are regulated by, ultimately the CFTC, and stock index options that are ultimately regulated under the authority of the SEC.

I do not see what is wrong with that.

It is not deregulation of the entities.

It is not like having the S&L's decide they want to be regulated by the FDA.

It is a decision by the issuer and the purchaser of the instrument where they want to go to sell it, and where they want to go to buy it.

And if you can work with the other regulators and come up with better language to ensure that that is the case, I would be happy to consider it, and I believe I speak for my colleague and others, that that is the clear intention.

I see my time is up, Mr. Chairman.

I do not want to deprive anybody else of the opportunity to get into this, but maybe there should be, if there are any responses to my question?

Mr. BREEDEN. I would simply say, Senator, that we read the language as providing exactly what you suggested, a jump ball.

When a product can be construed to be a future by the CFTC, then they can license it for trading.

And when it can be construed to be a security by the SEC, we could license it for trading.

And if the same product or a similar product is trading on both exchanges in the same way that the CBOE trades the option on the S&P 500 Index, and the Chicago Merc trades the future on it, that

is direct competition and both are under thorough systems of regulation and there is nothing wrong with it.

Dr. GRAMM. Are you——

Mr. BREEDEN. So we would be happy to endorse any necessary corrections to satisfy concerns by the CFTC that that would be what the language would provide.

Dr. GRAMM. Are you suggesting, Senator Bond, that if stock index options, or options on individual stocks, or futures on individual stocks, et cetera, that if somebody wanted to offer them for sale on a futures exchange, that that would also be allowed?

Because now some of those are banned, and some of them are under the SEC's jurisdiction.

Is that your intention?

What about securities? Could they also be traded?

Senator BOND. The narrow future on an individual stock, the stock itself——

Dr. GRAMM. Right.

Senator BOND [continuing]. Having been regulated by SEC, I believe it has already been agreed that an individual future on a particular stock——

Dr. GRAMM. What about——

Senator BOND [continuing]. Should not be.

But clearly we have the stock index—the indexes are traded in both areas.

I believe that trading on an individual instrument would be——

Dr. GRAMM. Under the Shad-Johnson accord, the CFTC-regulated stock index futures and stock index options were under the SEC regulation.

That was a deal that was——

Senator BOND. We would propose not to change that.

Dr. GRAMM. So that the competition only goes one way then—futures products can be sold if the SEC determines they would like to sell it——

Senator BOND. No.

Dr. GRAMM [continuing]. But competition does not go the other way, that an issuer could decide that they want something sold on the futures exchanges?

That does not sound like competition to me.

Senator BOND. No, I think you do have competition, but I do not think that you have a situation where you are going to have the SEC trading a security that is a wheat future.

Dr. GRAMM. They could, under that bill.

Senator BOND. Well, then I think that that—I would appreciate the drafting expertise, and if you would work to provide that language I think the intent is clear.

We have had a disagreement on what is the purpose.

But I am saying on a stock index future, or a stock index option——

Dr. GRAMM. So a stock index option could come back to be traded on a futures exchange? Is that what you are suggesting?

Senator BOND. You have a stock index future.

It is a future when it trades it on a futures exchange. And you have to——

Dr. GRAMM. But what about stock index options?

Senator BOND. They are traded on the securities exchange.

Dr. GRAMM. If an issuer wanted to sell it on a futures exchange, are you suggesting they should be allowed to—in the spirit of the competition of the Bond-Wirth bill proposal?

Senator BOND. They can trade it as a stock index future on a futures exchange, or an option.

Maybe I should ask, Mr. Chairman, there seems to be a couple of gentlemen at that end of the table who wish to comment.

Mr. GREENSPAN. Yes, Senator, there is another principle which is going to emerge if we are going to be getting competing products on different exchanges.

We have seen over the years a very significant tendency for competition to tend to move the volume of activity from one exchange to another.

Years ago I recall there was significant competition between the New York Cotton Exchange and the New Orleans Cotton Exchange. They were both selling the same contract at the same point of delivery with the same specification with respect to staple length and the like, and eventually the volume from the New Orleans Exchange, as I recall it, moved to New York.

That principle works in virtually all exchanges. That is, if you have a similar or specifically an identical product, it will tend to move to one exchange or the other, and there true market competition is determining which is the appropriate vehicle for that.

In this context, and under your specifications, what would occur is that there would be a single regulator, but that would be determined by the market. And that would be most appropriate in those conditions.

Senator GRAMM. Mr. Chairman, may I ask a question related to this?

Senator BOND. Let Mr. Glauber finish, and then——

Senator GRAMM. All right.

The CHAIRMAN. Yes, when Senator Bond yields I would be happy to.

Senator BOND. I will be happy to yield after——

The CHAIRMAN. Go ahead.

Mr. GLAUBER. My point relates to something you said at the beginning, Senator Bond. You now have been involved in two attempts at compromise on this issue. You described the first one as having been hijacked. I would say what has happened is it has run into the legislative dead end that so much that we have tried to do on these issues has so far.

I am just anxious that in trying to perfect something we not send any of this compromise which is embodied in title III into a legislative dead end. It is, I think, crucial that we make progress. It was in that spirit that the Secretary embraced this compromise.

It contains, as I have said before, one element which we consider to be of great importance, and I believe you do as well, on stock index futures margins.

We have said that we believe title III is a modest improvement on the issue of exclusivity. I would certainly say that what you propose comes closer to what we originally proposed. But as Senator Dixon quoted earlier, I hope we will not make the best the enemy of the good.

Senator WIRTH. If the Senator would yield, I would hope that we would also get the support of the administration really working on this, which is what we did not have the last time around in that so-called "legislative dead end." We ran into a noncommitted swamp.

Senator GRAMM. Well, Mr. Chairman——

The CHAIRMAN. I am next in the order, but you have asked me to yield briefly, and I yield to Senator Gramm.

Senator GRAMM. Well, Mr. Chairman, it seems there are two issues here. I think, No. 1, any reasonable person reading the language of the Wirth-Bond substitute has to conclude that if the CFTC and the SEC differ, then the SEC dominates. That is the first issue.

The second is that this is freedom in one direction. This is a freedom that says that if you have a futures product and you want to trade it on the equities market and you are close to the margin, you can do it, but you can't go the other way with a securities product. That is freedom going in one direction. You can join a political party as long as it is the Communist Party. That is freedom. [Laughter.]

Now let me ask the people sitting down there who are against exclusivity: Would you be willing to support a modification in the Wirth-Bond proposal that would allow hybrids to go in the other direction?

What the Treasury and the CFTC and the Agriculture Committee have done is they have recognized the essential nature of futures products. The Agriculture Committee bill is based on 70 years of regulatory history, recognizing the fact that a future obligates you to something, something that very few people around here, unfortunately, understand.

Whereas, selling an equity is an arm's-length transaction. You have sold it. You are out of the loop.

We have decided, based on that difference, to have one set of regulations for futures and another set for securities. The proposed Agriculture Committee compromise here is a bright line at 50 percent.

Now the proposal that is made by Bond and Wirth is: Let the offeror of the instrument choose.

Now are you willing to support letting them choose going in the other direction? An instrument is 55 percent equity, 45 percent future. The SEC says, this is our baby. We own this baby. We love this child. [Laughter.]

We love this child. Now are you willing to let them opt to trade in Chicago on the futures market?

Yes, or no?

Mr. GREENSPAN. May I elaborate a little bit?

Senator GRAMM. Yes.

The CHAIRMAN. Not at great length, because we are on my time.

I am happy to have him make a comment, but not to take question period.

So why do we not go ahead and have brief responses.

Mr. GREENSPAN. The answer is yes.

But I am not comfortable with the 50-percent rule, which I have great difficulty with at the margin because it could switch back and forth.

But alluding to the principle I was mentioning earlier,

I have no difficulty with an instrument endeavoring to be offered on two separate exchanges, one a futures exchange, one a securities exchange, because I do believe that the competitive pressures will move the volume to the most efficient vehicle for transaction.

I therefore would have no trouble with that.

Senator GRAMM. Mr. Glauber.

Mr. GLAUBER. Senator, as a matter of policy I would have no objection at all to encouraging competition.

Indeed, I would support it. I would simply point out that the compromise embodied in title III moves somewhat in that direction.

Senator GRAMM. That is in the Ag bill, is it not?

Mr. Breeden.

Mr. BREEDEN. I would fully agree with the proposition you suggested.

If it was a hybrid security, whether it is 55–45 one way, or 45–55 the other, the developer of the product should be able to choose which exchange to put it on with no restrictions.

Though we would love that child, we would be very happy to have its cousin or its brother or sister traded on a futures exchange.

Dr. GRAMM. Let me clarify your proposal.

It is what I call the "let a thousand flowers bloom proposal," and you are not talking about just hybrids.

You are also talking about letting futures trade as a security and be called a security to customers.

You are also talking about letting stock index options and letting options on individual stocks be traded on futures exchanges.

Senator GRAMM. Oh, exactly.

Dr. GRAMM. That is the letting 9,000 flowers-bloom approach.

Senator GRAMM. Futures on an individual stock would be a hybrid, and they could opt to trade——

Dr. GRAMM. Or anything. They could be anything. Anybody can trade.

And that is letting individual futures, futures on individual stocks, options on individual stocks trade anywhere.

I would just submit to you, Senators, that is a very radical change from the functional regulatory approach that you have set out over these past 70 years, and I would say that our approach is a modest step.

But what you are suggesting is quite a radical approach.

I would also like to point out that there has been a lot of confusion over the word "competition." I think Chairman Greenspan was very correct when he mentioned competition. We have competition on the futures side; there is nothing that prevents the CBT from mimicking any futures, even if it is sold on the CME and traded there.

There is a lot of competition—and let me tell you, the competition is fierce, especially between those two firms.

It is cutthroat.

What we are talking about here is not that kind of competition.

A "monopoly" refers to a single seller.

The Commodity Exchange Act does not establish monopolies in any way, shape, or form.

What you are talking about here is simply if it is a future, under what regulatory regime should it be sold? If it is a security, under what regulatory regime does that product sell?

And again, there is a regime that you have established.

The CHAIRMAN. Now let me, having sort of given my question period over to Senator Gramm——

Senator GRAMM. And it was well used, Mr. Chairman. [Laughter.]

The CHAIRMAN. Well, I am sure you feel that way.

Senator GRAMM. That was a wise decision.

The CHAIRMAN. I am sure you feel it was. I mean, watching that it was sort of like watching a professional basketball team going down the court as the ball was going back and forth.

In any case—and I admire the teamwork, I might say. [Laughter.]

I want to come back to the original format of the questions I asked at the outset, and I want to put the question out on the table again now with respect to another measure of the Wirth-Bond substitute as opposed to the S. 207 version as revised by the CFTC.

I want to test them side by side simply on the issue of which one offers the greater legal certainty.

Some of us on this panel are not lawyers, so we do not relish the notion of constantly having hordes of lawyers at play struggling over these issues in the courts and outside the courts forever, and at great expense and with a lot of uncertainty.

With respect to just the issue of legal certainty, Chairman Greenspan, would it be your view that the Wirth-Bond alternative would carry with it greater legal certainty?

Mr. GREENSPAN. Well, I am not a lawyer either, Mr. Chairman. I can certainly say that——

The CHAIRMAN. One of your attractive qualities. [Laughter.]

Mr. GREENSPAN. It certainly reduces economic uncertainty and, I would presume as a consequence, creates greater legal certainty.

The CHAIRMAN. I would think it does.

Mr. Glauber.

Mr. GLAUBER. My sense is to agree with that. Let me just emphasize that I think both of these alternatives provide more legal certainty than the current state of affairs.

The CHAIRMAN. All right. But as to which one offers the greater amount, I take it that your answer is that the Wirth-Bond alternative would appear to do that?

Mr. GLAUBER. My qualifications are not preeminent in this area to render a judgment.

The CHAIRMAN. Well, I know, but that does not mean you can go out the side door and not give a judgment.

Mr. GLAUBER. I just gave one.

The CHAIRMAN. Very good. I thought you did. I take that as a yes, again, and——

[Laughter.]

Mr. GLAUBER. I am very happy to say very directly, yes. I just wanted to point out that I also am not a lawyer.

The CHAIRMAN. I understand.

Mr. Breeden—which is one of your redeeming qualities, as well. Mr. Breeden.

Mr. BREEDEN. No lawyer—and I suffer from that affliction—could say that an exemptive process provides more certainty than an exclusion process without committing malpractice and being disbarred. It is unequivocally clear that the exceptions provided in Bond-Wirth are much more certain to permit the developer of a product to be able to trade that product than the vagaries of an exemptive process where an agency may or may not conclude that the magic tests have been met.

Yes.

The CHAIRMAN. And, Ms. Gramm, just with respect to the narrow issue of legal certainty, which of the two alternatives offers greater legal certainty, in your view?

Dr. GRAMM. There is no doubt in my mind that the alternative in S. 207 has more certainty. You are talking about a simple mathematical test.

I am not a lawyer, but I have dealt with lawyers on this issue over the last few weeks, and it is quite clear—clearer than you have seen in much legislation. Very frankly the 50-percent test is something that is being done now on a smaller scale by financial engineers, and it is a very simple test.

I know that lawyers might be confused about it, but it is not confusing to the practitioners. I think the difference between the S. 207 and the Wirth-Bond proposal is the difference between a $10 calculator and a $1 million lawsuit, and I feel quite strongly about that.

The CHAIRMAN. I am going to yield in a moment here to Senator Garn.

There is an issue that we have touched on that we have not focused sufficiently on in a letter that has been addressed to the committee from Mary Shapiro who rather uniquely has served both on the SEC and also as the General Counsel to the CFTC, relating to the issue of the health of our capital markets with respect to attracting investment capital and working it back out into the system to finance our economic activity.

But let me just yield to Senator Garn. I think he wants to make that point, and I yield for that purpose.

Senator GARN. Thank you, Mr. Chairman.

In my opening statement, I asked unanimous consent that this letter be included in the record, but I felt it important to highlight it.

I will only read a couple of paragraphs, because it is four pages long, single-spaced, but I think it should have more attention than my just putting it in the record:

> I am writing as a member of the Securities and Exchange Commission, former staff member of the Commodity Futures Trading Commission, and General Counsel of the Futures Industry Association, to express my concern with Title III of S. 207.

The reason I wanted to read that part is, maybe she is the only one without a bias, having served as——

Senator GRAMM. She works for the SEC. How can she not have a bias? [Laughter.]

Senator GARN. Well, Phil, we all have biases, but I would suggest that she—let me modify my remarks, then, to suggest that she is the only one that has experience in both areas, having worked for both the CFTC, and SEC, and as General Counsel of the Futures Industry Association.

At the outset, let me state that whatever its merits for the regulation of futures contracts, I believe that the exclusivity clause of the Commodity Exchange Act is doing damage to the capital-raising ability of U.S. corporations. Quite simply, the exclusivity clause deprives U.S. corporations of needed flexibility in designing their capital instruments and hurts U.S. investors, particularly retail investors, by denying them the opportunity to invest in the financial instruments of their choice.

Another paragraph, or sentence:

Finally, the limitations of S. 207 on index participation, IP's, lack any grounding at all in logic. The bill would deem all Index Participations to be futures, and then would exempt from CFTC regulation only the eight IP's that were approved or pending before December 31, 1991.

The rest of the letter is included in the record.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

I think we are just going to go, in the interests of time today—we have caucuses in which these matters are to be discussed, both parties, and so I want to accommodate the two colleagues that are left to go here.

And then, unless there is a compelling demand, I think we will not go to another round.

Senator Dixon.

Senator DIXON. Well, Mr. Chairman, let me just say in the interest of brevity, then, that at the conclusion of this hearing that I see here, in my view, sort of an extraordinary event.

We have had a hearing here in the Banking Committee on a bill, S. 207, produced by the Agriculture Committee by a unanimous vote of all members of that committee, the majority and the minority, all Democrats and Republicans, voting for that bill.

I guess the reason for this hearing was an assertion that, by the passage of that bill, or the markup of that bill in the other committee, that we, at some time, somehow, imposed on the jurisdiction of the Banking Committee. But it is as clear at the end as it was at the beginning that we have not.

The consequence of this bill is, in effect, not to impose in any way on the jurisdiction of the Banking Committee, but in fact to add some jurisdiction, in my view, to that of the Banking Committee.

So that the final result that I see here is the sort of tremendously extraordinary circumstance where some here would suggest that they want to change a bill, the product of another committee, that is in that committee the product of a compromise where the Secretary of the Treasury, represented here very ably by Mr. Glauber, tells us that the disparate points of view of all these groups were heard, including the regulatory agencies involved who are represented here today, and the industries involved as well, and a compromise has resulted.

Now in that situation, seeing that there is only one representative separate from the regulatory agencies here, the representative of the Secretary of the Treasury who is a part of the Cabinet, I

would simply ask him in conclusion, after everything that has been heard, Mr. Secretary, is it a fact that the administration was involved in the honorable accommodation that took place in the Agriculture Committee in which all people and all points of view were heard that ultimately resulted in the markup of S. 207?

Mr. GLAUBER. I think we understood the position of all the parties, and obviously we were involved in the compromise.

Senator DIXON. And is the administration now here to suggest that its imprimatur is still upon that compromise?

Mr. GLAUBER. Our position is stated in the statement of administration policy, that we generally support title III, as it will be amended by the managers.

Senator DIXON. I thank the Secretary.

The CHAIRMAN. Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

I would just point out that the measure which came out of the Agriculture Committee had not been commented on by witnesses before that committee. It was reported out, I understand, after less than a quarter of an hour of debate.

But when it was reported out, this committee and many Members of Congress were overwhelmed with significant concerns from institutions and participants whose activities generally are subject to the jurisdiction of this committee, saying that it would have very significant adverse effects.

We are here to discuss the possibility of amendments based on the information that we received from the witnesses before us.

I might ask three members of this panel: In Chairman Gramm's testimony, she says that title III does not provide, and the CFTC has never ruled that swap products are futures.

If the CFTC does not believe swap agreements are futures, why should it be necessary for Congress to provide an exemption or an exclusion for swaps under the Federal commodity laws?

I might ask that we start with Chairman Greenspan.

Mr. GREENSPAN. Well, the fact that there is a question about this I think certainly requires clarification in one way or another.

Senator BOND. Mr. Glauber.

Mr. GLAUBER. I think it requires clarification, as well, Senator Bond. We have worked hard on that portion of title III to make it clearer, and I think we have accomplished that.

Senator BOND. Mr. Breeden.

Mr. BREEDEN. I think the objective of the Wirth-Bond proposal of excluding swaps with certain characteristics, rather than subjecting them to exceptions, is the clearly preferable approach. That is why the Swap Dealers Association in a letter dated yesterday wrote and said that their strong preference was for the Bond-Wirth alternative rather than for the proposed S. 207 as modified.

I would be very happy to provide a copy of that letter for every member of the committee.

Senator BOND. I might ask, Dr. Gramm, why should we not just clarify that swap agreements are not subject to CFTC regulation under the Federal commodities law?

Dr. GRAMM. As you know, Senator, the CFTC for the last 2 years has stated through a policy statement, and otherwise, that swaps

as they exist today are not futures under the regulation of the Commodity Exchange Act.

However, the swap dealers did want to use, and they felt very strongly that we use in this bill a definition of "swaps" that comes from the Bankruptcy Code. It only defines "swaps" by saying a "swap agreement, means on agreement (including terms and conditions, et cetera), which is a rate swap agreement, a basis swap, et cetera."

It goes through and lists all the things that might be a swap agreement, including "currency options and any other similar agreement."

Given this very broad definition of a swap that we are using in our provision, we believe that it is important that you limit and explain very carefully what is a swap to be exempted and what is not.

Specifically, what is not to be exempted is a futures product trading on an unregulated exchange, but that has just a label on it called "swap." Somebody could argue that that certainly is "another similar agreement" to what are currently swaps.

That is a definition from the Bankruptcy Code that we are using, and it is because of the broadness of that definition which the swap dealers wanted to use that we have written the proposal in this way to continue to provide the protections of the futures regulatory regime.

Senator BOND. But by setting it up in terms of an exemption, requiring a hearing prior to it, an individually negotiated swap would then have to come before the CFTC to get an exemption?

Dr. GRAMM. Let me be clear that what we mean by "hearing" is not a trial-type hearing.

All we are talking about is, in any kind of exemptive process, or rulemaking process, at the beginning you go through the administrative procedure—the notice and comment process that would allow all interested parties to comment.

But then it would be self-executing. They would not have to come to us for special exemptions after that process.

Senator BOND. As I read this—and unfortunately I have been a lawyer in my day, and I cannot get over that; I must confess to having done it—seeing that, I would have to advise anybody I was advising on a swap that they would have to go in, if they fashioned a new swap, go through a hearing and an exemption process, and then be subject to revocation. The exemption given can be taken away.

And I would have to say, under the terms of S. 207 as provided, there would be no option other than to tell them that you had better move swaps offshore.

We have already seen IP's being driven offshore, not by the Securities and Exchange Commission but by legislation, by litigation and I am afraid that swaps will join Brent Oil and IP's abroad if we have that solely phrased as an exemption.

Mr. Chairman, I hope that we can work with, and we would be happy to accept today any suggestions of language clarifying the purpose which Senator Wirth and I sought to achieve of providing that a hybrid instrument which is partially—and I do not care whether it is 45-55 or 55-45—could be set up to be traded on a con-

tract exchange, and that if it was a CFTC administered exchange, no finding by the SEC would be necessary or even appropriate to say that the hybrid product is a future which can be traded under CFTC jurisdiction.

That was the purpose in dealing with hybrids, and it is to be a two-way street.

I personally think that the language accomplishes that, but I would be happy to have any additional language or suggestion thereto.

The CHAIRMAN. Let me just indicate that the Banking Committee and its members and professional staff were not a party to the discussions that yielded the agreement that materialized out of the Ag Committee late one evening.

With all due respect to that committee, and I have great respect for it and for its chairman, as I have stated other times and places, I have talked to members of the Ag Committee that frankly acknowledged to me that section III is a mystery to them.

It was not something that was ventilated to any great extent at the time, and it is arcane. I mean, this is the work of lawyers and regulators with expertise in this area that is way beyond the normal course of legislative work that we are called upon to do here.

So it is important that it be clarified. It is important that it be understood that we have a hearing record such as we have been developing today.

Now having not been a part of the deliberations that led to this compromise, which I think on its face is deficient in ways that have been pointed out here today, it ought to be improved. And I am for improving it.

I am for finding some workable way to get it done, and not just have an all-or-nothing situation where it either goes precisely as it has come out of the Ag Committee, or it goes down precisely as it has come out of the Ag Committee.

I think Senators Bond and Wirth are performing a very useful exercise, together with a number of other Senators of both parties who have spoken here in this committee today—Senator Domenici, Senator Kassebaum, others—to try to fashion a way to resolve this.

I will be very blunt about it. I have been around here a long time myself and regulators come and go. Some are good, and some are not, in terms of just their performance. And sometimes you do not even know for years later as to who did a good job or who did not.

In my view, that is incidental. I do not care at the moment in terms of this discussion who runs what, because there is always going to be tension. There is always going to be a certain amount of jurisdictional jockeying, and some of that is appropriate. That is the nature of the way institutions have to rub up against each other in terms of trying to sort some of these things out.

But in deciding it in the end, I would hope we would never decide a policy based on who a given regulator is at a given time, because no regulator stays for very long no matter who they are or how good they may be.

So we ought to be building a regulatory regime that has nothing to do with who runs what in terms of the personalities, or the faces, or who they are today. We ought to be looking at a regula-

tory regime that is going to suit this country well 5 years from now, 10 years from now, and on into the future, and to think about it in those terms.

I think it is important that it be depersonalized. I think it is important that the regulatory enthusiasm and passion that all regulatory agencies have be put to the side in terms of sorting out these questions.

And in that sense, I must say I rely quite heavily here today on the testimony of the Chairman of the Federal Reserve System. It is an awkward situation for any of us to find ourselves in the middle of these kinds of debates and conflicts that go back and forth, and I can understand why the administration is in a position of its own.

They were party to the deal. They cut a deal. They may not like all aspects of the deal right now.

They may see things that they would like to change, and so forth, and I understand why they feel they may be pinned down. And even if they see something that is better, that the "better" should not be the enemy to the good, et cetera, et cetera.

Well, I understand that. But I do not think we ought to be setting policy in major policy areas for the future based on people getting themselves locked into arrangements late in the evening on some night.

We are all parties in interest but we did not all participate.

All the relevant parties of interest should have been participating. But that clearly was not the case in this instance.

That's one of the reasons why we're having this hearing today.

We wouldn't be here and we wouldn't have this list of witnesses, but for the importance of this hearing and the factual record that's being developed.

So the apprehensions I've heard you state, I think fairly, clearly, in a balanced fashion, not tilting toward or against anybody, not tilting toward any kind of regulatory regime versus the other, but a more arm's-length assessment of the situation, I find to be very useful and very helpful, and I appreciate it.

And I appreciate the difficulty of trying to do that in a situation where all the factors are in play, such as we see them.

But in the end, I think we better be building the strongest possible capital markets we can in the United States, and we better be facilitating the movement of capital from savers into the hands of investors, and all of the means by which we lay off risks back and forth and I'm talking now about the financial structure, I'm not into agricultural issues. That's separate and apart, in my view from what we're talking about here.

And the same, I just want to say this, with respect to markets.

I have tremendous admiration for the ingenuity and for the innovative of the Chicago markets.

I don't know that there are any markets anywhere in the world, in terms of individual markets, that have demonstrated an ability to be innovative and to pioneer more than they have.

And that shouldn't work either for them or against them in terms of us settling this question now.

But I have no brief, nor will I carry any brief, or allow this committee, insofar as I have anything to do with it, to carry a brief one way or another for one market versus another.

We shouldn't do that.

We ought to be able to handle things in as evenhanded a way as we can, so the markets have their own opportunities to face off with each other, and to do that job that the individual investors around the country and around the world feel need to be done.

So if we can have that kind of an evenhanded regime, as best we can accomplish it, that is durable and solid for the future, balanced, fair, open, I think we will have done as much as we possibly can do.

And so that will be the approach that I intend to try to take, as one participant among many here.

I want to say, in conclusion, that I admire and appreciate the work of Senator Bond and Senator Wirth, in trying to fashion an answer here that I think attempts to try to be as evenhanded as possible.

And it may not, in all respects, be acceptable to the CFTC or in all respects acceptable to the SEC or anybody else. That shouldn't be the final test.

The final test should be, does it have some sensible balance that gives us stronger markets for the future.

And if so, then that would be a good outcome, and one that I would hope we can do something with.

Senator DIXON. Mr. Chairman.

The CHAIRMAN. Yes, Senator Dixon.

Senator DIXON. I appreciate everything that the chairman has said.

And I know that the chairman understands my tremendous personal affection and respect for him and the efforts that he makes as chairman of this committee.

I feel compelled to make two observations, if I may, please.

In connection with my good friend, the distinguished chairman's observations and the observations made by my friend from Missouri.

And the first is this.

With respect to this continued conversation about compromise, I'm absolutely, Mr. Chairman, compelled to state that compromise is the product of a result of an accommodation of honor between people when everybody's involved.

There was no compromise discussed before with this Senator or with the industry, which is so significantly economically important to his State, at any moment, before the compromise that was the result of S. 207, in the 3½ years it has gone on, whatever else was called a compromise, had no player from my side of the perspective of this disagreement, ever involved in what was functionally called some previous compromise.

That ought to be the number one thing.

And, second, I would want to say in deference to the statement made by my friend from Missouri, who talked about this 15-minute result.

This Senator in this committee offered, in a 15-minute meeting some years ago, the amendment that resulted in what we then called the Proxmire Financial Modernization Act.

It took 15 minutes in this room.

And some of the people in this room were here when that happened, and it was a product of years of discussions.

And I want to say to the Chair and my friend from Missouri, both men I respect a great deal and have infinite joint affection in working with over the years, this is the result of 3½ years, as well.

I understand there's some passions involved around here.

But to suggest that anything's been done in the dark of night is without any functional support anywhere.

This is a product of 3½ years of very bitter, contentious disagreement from time to time.

That's OK with me.

That's what this job is all about.

But this is, in fact, a compromise, that the administration was involved in, that all of the agencies and regulatory agencies are involved in, that the New York and Chicago markets were involved in.

And I don't have any problem with that.

The CHAIRMAN. Let me call on both my colleagues here for closing comments, and then I think we'll bring down the curtain here.

Yes?

Senator GRAMM. Mr. Chairman, let me try to sum up my feelings. I think this has been a helpful hearing.

I basically find myself in agreement with the general thrust of your comments.

But here's where we are.

We have a compromise adopted by the committee of jurisdiction, the Agriculture Committee. I'd like to be on every committee. I'd like to run the U.S. Senate. [Laughter.]

Unfortunately, it doesn't work that way. They had the jurisdiction. They hammered out an agreement. The proposal of Senator Bond was not hijacked, it was defeated. It was defeated in an up or down vote.

We call that system democracy. We call it the manifestations of choice. Now, the committee of jurisdiction put together a compromise. It is not my choice. I personally like the position of the House, which is to authorize an agency and debate these issues somewhere else. I call it hijacking to hold an agency hostage to try to promote some agenda, other than the efficient operation of that agency. So I support the House position. I am going to vote for the Ag Committee compromise to get this issue over with.

We are talking about a fundamental change in American law, however, when we are letting people choose their regulator, a fundamental change. Now, quite frankly, I haven't prayed over this, so it may be a principle that I want to adopt generally.

But let me tell you, if we're going to adopt this new principle, we're going to adopt it generally. And we're going to adopt it in agencies that today don't want it adopted in their jurisdiction. Let me also say, if we're going to let instruments choose, we're going to let all instruments choose.

And if we're going to go down this road, and I am fairly confident that my colleagues are going to decide that it is not prudent, but if we decide to go down this road, we are going to vote on letting instruments such as futures on individual stocks trade on the

futures market. You can't justify letting instruments move in one direction, and not letting them move in another.

So if we're going to change dramatically the regulatory system of the country, which in my opinion, is not prudent policy on a reauthorization bill, then we better be ready to have lots of debates about fundamentally changing the regulatory structure of this country.

Maybe we're ready to do it; I think that it's premature.

I think that maybe the New York exchanges, when they think about individual stock futures in Chicago, will decide that this is not how they would like to see things done.

But if we're going to let people choose, if we're going to let instruments move back and forth across markets, and maybe that's the way of the future, they're going to move in both directions. I cannot believe that if this body is so foolish to start down this road, that they're going to leave it one sided.

I can't believe that's going to happen, and I think that's something we ought to ponder.

The CHAIRMAN. Senator Bond.

Senator BOND. Mr. Chairman, I hope that you'll excuse me if I don't express the same enthusiasm and eloquence of my dear friend from Texas and my dear friend from Illinois.

This is an emotional and very passionate issue.

We worked long and hard, last year, with representatives of the Agriculture Committee and representatives of the Banking Committee.

I happen to serve on both.

And when we came up with a compromise, it was a compromise involving both areas, both the CFTC authorizing committee and the SEC Committee, this committee.

Now that was a compromise.

It did not, obviously, have the blessing of my friend from Illinois, and that's one of the reasons it did not come up on the floor.

When we had the compromise introduced by Chairman Leahy and Senator Lugar, both of the Agriculture Committee this year, it was substituted with something that was not a compromise, that did not involve members of the Banking Committee or their staffs, or the SEC.

We are proposing here something that I believe has the ability to break the logjam and to avoid the absolutely ludicrous situation we have now, where instruments that are neither pure securities nor pure futures—and we're not talking about single stocks, we're not talking about a wheat future, we're not talking about those classical instruments now traded on different exchanges; we're talking about ones in the gray area in between.

And just as a purchaser or a seller can choose to go into the stock market for a stock index option, or into the futures market for a stock index future, that is the kind of mobility that the Chairman of the Federal Reserve has said would provide competition and the best climate for financial markets.

And I happen to agree very much with the distinguished chairman of this ⅓committee, that in issues of this complexity, I think we would all do well to follow the guidance of the Chairman of the Federal Reserve, who is in a unique position to look at these chal-

lenges, and to see that the final product of our work is one which promotes, rather than inhibits financial industry competition in the United States.

The CHAIRMAN. We've had a good hearing this morning.

I want to thank all the members for their participation.

I want to thank our distinguished witnesses for their participation.

The committee stands in recess.

[Whereupon, at 12:22 p.m., the committee was adjourned, subject to the call of the Chair.]

[Response to written questions and additional material supplied for the record follows:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BOND FROM

ALAN GREENSPAN

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

May 21, 1991

ALAN GREENSPAN
CHAIRMAN

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of April 24 requesting a response to questions related to the April 16 hearing on jurisdiction issues in S. 207, the CFTC reauthorization legislation. I am pleased to submit the enclosed response to complete the hearing record.

Sincerely,

Enclosure

Chairman Greenspan subsequently submitted the following in response to written questions from Chairman Donald W. Riegle, Jr., in connection with the hearing held on April 16, 1991.

Q.1. The Bond-Wirth Alternative would exclude from the federal commodity laws bank deposits and loans made by federally insured depository institutions.

(a) Do you support these provisions? If not, why not?

(b) Under current federal and state banking laws can banks convert loans and bank deposits into futures contracts? If so, how?

A.1.

(a) As I have previously stated, I support a statutory exclusion from the provisions of the Commodity Exchange Act for deposits and loans made by financial institutions. Deposits and loans, on the one hand, and futures contracts, on the other, are essentially different types of transactions undertaken for different purposes.

Deposits and loans are financing transactions in which one party lends the other party the use of funds for some period of time, generally in exchange for the payment of interest. The amount of the loan or deposit is transferred to the borrower, and is later repaid, along with any interest payments required for use of the funds. The purpose of a loan or deposit from the lender or depositor's standpoint is generally investment, while the purpose from the borrower's standpoint is to obtain funds which, in turn, may be used for investment or other purposes.

These purposes are recognized by Federal law. The National Banking Act defines "loans and extensions of credit" to include "direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person . . . " 12 USC Sec. 84(b)(1). Federal courts have applied similar definitions in determining whether a contract is a loan. For example, in Calcasieu-Marine Nat. Bank, Etc. v. Am. Emp. Ins., the court stated that "[i]n order to constitute a loan there must be a contract whereby, in substance one party transfers to the other a sum of money which that other agrees to repay absolutely, together with such additional sums as may be agreed upon for its use." 533 F.2d 290 (1976) quoting In re Grand Union, 2 Cir. 1914, 219 F. 353.

Similarly, a deposit is a form of a loan, in which the borrower is a bank or other depository institution. Under the Federal Reserve Act, the Board is empowered to define the term "deposit" for the purposes of implementing reserve requirements and the prohibition against the payment of interest on demand deposits. The Board's definition of "deposit" includes a variety of depository institution obligations that represent unpaid balances of money received or held by depository institutions, as well as other obligations undertaken as a means of obtaining funds. 12 CFR Sec. 204.2(a). Under this definition, however, accrued liabilities for future payments are not deposits.

The Commodity Exchange Act refers to futures contracts as contracts for the purchase or sale of a commodity for future delivery. Under traditional futures contracts of the type traded on a futures exchange, two parties agree to make a purchase or sale at a specified price with the payment and delivery to occur at some future date, or, in the case of cash-settled contracts, to make a payment based on the difference between the previously agreed price and the market price at the expiration date of the contract. The contract is executory, as each party has future obligations to fulfill under the contract. While the price of the contract is agreed upon in advance, the buyer does not actually pay the full price of the contract at that time. The only payments made are margin payments, which serve as security for the future performance of the parties. See generally In re Rawlin L. Stovall, Comm. Fut. L. Rep. (CCH), Sec. 20,941 [1977-80 Transfer Binder].

Unlike bank deposits and loans, which are financing transactions used to obtain and use funds, futures contracts are designed to assume or shift the risk of price movements to one party or another, either for hedging or speculative purposes. Although deposits or loans may incorporate risk-allocating elements based on movements in market prices, they are still primarily financing transactions. Any elements of the transactions that resemble the risk-shifting characteristics of futures contracts are secondary to the predominant purpose of the transactions. Further, a loan or deposit is not an executory contract, as the lender or depositor has performed its part of the contract by making the initial transfer of funds to the borrower or depository institution. The borrower or depository institution then has an obligation to repay the funds received, along with any payments of interest.

In contrast, in a futures contract there is neither an initial transfer of money in the full amount of the contract nor an obligation to repay that money. Both parties to the transaction have an obligation to perform at the settlement date of the contract. A futures contract is both bilateral and executory, and would not be either a "deposit" or a "loan," as no initial sum of money has been lent or debt incurred, and because payments under the contract do not represent compensation for the use of any funds transferred between parties.

Finally, the language offered by Senators Bond and Wirth, which has now been incorporated into S. 207, limits the exclusion to "deposits," as defined by the Board under the Federal Reserve Act, that are offered by insured depository institutions or by foreign bank branches or agencies that are subject to federal oversight. The exclusion for loans is limited to loans from such institutions, loans from foreign banks to sophisticated participants, and loans covered by the Truth in Lending Act. As a result, the exclusions would apply only to loans or deposits offered by entities that are already subject to comprehensive regulatory oversight, including regulations designed to protect bank customers, or, in the case of foreign banks, would be limited to sophisticated customers that are able to evaluate these transactions on their merits. I believe that these limitations are sufficient to ensure that exclusions for these transactions will not be used to take advantage of unsophisticated bank customers.

A.1.
(b) A bank cannot "convert" loans or deposits into futures contracts. A bank could enter into a futures-type contract to buy or sell loans or deposits for a set price at a future date. For example, a bank could enter into a contract to deliver 1-year certificates of deposit with a face value of one million dollars at a future date for a price reflecting the market value of the certificates of deposit. Although the instruments underlying such a contract would be deposits, the contract itself might be considered a futures contract if it did not fall into the exclusion in the CEA for forward contracts. Such a contract could not itself be classified as a loan or a deposit, and would not be exempted by the loan or deposit exclusions currently provided in S.207.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE COMMISSIONER

April 5, 1991

The Honorable Jake Garn
United States Senate
505 Hart Senate Office Building
Washington, D.C. 20510-4401

Dear Senator Garn:

I am writing as a member of the Securities and Exchange Commission and former staff member of the Commodity Futures Trading Commission ("CFTC") and General Counsel of the Futures Industry Association, to express my concerns with Title III of S. 207. I do so separately because I would like it to be clear that my concerns arise not out of any issue of jurisdiction or prior debates which have been characterized as turf wars; rather, given my experience with both futures and securities markets, I believe it is important that I express my views on the implications of S. 207 for the securities markets specifically, and the capital markets in general.

At the outset, let me state that whatever its merits for the regulation of futures contracts, I believe that the exclusivity clause of the Commodity Exchange Act is doing damage to the capital-raising ability of US corporations. Quite simply, the exclusivity clause deprives US corporations of needed flexibility in designing their capital instruments, and hurts US investors, particularly retail investors, by denying them the opportunity to invest in the financial instruments of their choice.

The effects of the exclusivity clause are even more troubling because these effects were neither contemplated nor intended when the exclusivity clause was first drafted. For these reasons, I believe that many of the efforts to limit the impact of the exclusivity clause of the Commodity Exchange Act are to be commended. The exclusivity clause, contained in the Commodity Futures Trading Commission Act of 1974, that created the CFTC and introduced the modern scheme of regulation, was an important provision with two primary purposes. The first was to ensure that commodity futures contracts such as silver, copper, sugar and cocoa traded on exchanges would be regulated to the same extent as other, already regulated, exchange traded futures such as wheat or soybeans. Prior to the 1974 amendments, a rather curious situation had developed in which a growing number of nonregulated futures contracts traded alongside of regulated futures contracts. Congress sought to remedy this anomalous

situation by bringing exchange-traded futures under the CFTC umbrella.

The second principal reason for enactment of the exclusivity provision was to protect exchange-traded futures from interference by state regulators and the potentially adverse and costly impact of compliance with 51 different regulatory schemes. Congress recognized and repeatedly reaffirmed the value of a nationally uniform body of standards governing futures trading coupled with state antifraud enforcement.

Giving effect to these two purposes has been extremely important to the successful development of the futures markets. Preemption of state law, with the very wise carve-out for state antifraud provisions, has likely saved the futures exchanges, and financial intermediaries, enormous sums of money. In addition, the credibility, safety and soundness of transactions on futures exchanges have been promoted and enhanced by the inclusion of all types of exchange-traded futures contracts under the umbrella of federal regulation. I believe that the phenomenal growth of the U.S. futures markets since enactment of the 1974 law is testament to the salutary effect of comprehensive regulation. Indeed an increase of nearly 800% in transaction volume would not have been possible if institutional users did not have confidence in these markets -- confidence that I believe is born of a belief that the markets are comprehensively regulated.

As the SEC savings clause demonstrates, however, I do not believe that the exclusivity provision was intended or should be used to prevent securities products from trading on regulated securities exchanges or to prevent institutions from utilizing swaps and other legitimate instruments specifically tailored to their needs. This Committee and the CFTC have rightly recognized that the exclusivity provision now impedes the development of useful, innovative financial products. Unfortunately, the proposed solution does not address the problem and, indeed, makes matters worse.

The basic problem with the exclusivity clause in today's markets is well recognized: it requires that <u>all</u> instruments (even securities) with elements of futurity be treated as futures contracts and therefore required to be traded on designated contract markets or futures exchanges. As Chairman Greenspan has pointed out, the potential for the strict application of this principle has led to confusion in financial markets and the involvement of the courts, which in turn has discouraged efforts to develop new and innovative instruments.

The 50% value test proposed by S. 207 seeks to utilize a simple, seemingly objective calculation to determine when an instrument is a security or a future. In reality, however, a 50% <u>value</u> test is not a useful or objective measure because various

arbiters can measure the value of different parts of the instrument in a variety of ways based on different sets of assumptions. More importantly, certain products, such as equity hybrid instruments, simply cannot be broken into intellectually distinct pieces that can then be valued separately. As a result, the percentage test effectively guarantees that no new equity hybrid product will be able to trade. Further, I do not believe that such a test reduces the risk that there will be litigation over each new hybrid product. Hence, the chilling effect of the exclusivity clause will remain intact.

But, there is a further structural problem: if a securities exchange trades a product that the SEC has approved as a security and that exchange is sued on the grounds that the product has more than 50% of its value derived from a commodity, a court will not accord the SEC any deference for its determination because the SEC will be interpreting a commodities and not a securities statute. Rather, the CFTC likely will be asked for its view, and the CFTC will be accorded deference. In effect, the CFTC replaces the SEC as the agency with authority to determine what is a security. Thus, the chances that the innovators in our marketplaces will risk the introduction of new hybrid equity instruments are very small. That would be a very tragic and costly result.

Rather than employing an imprecise and perhaps unworkable exemptive test, I believe the best approach would be one that permits hybrid financial instruments to trade on either type of exchange. So long as the markets are regulated, and the public is protected, it is hard for me to discern any legitimate reason not to allow the exchanges and the regulated over-the-counter market to fully develop new products that meet the needs of investors. Let the SEC approve hybrid products for securities exchanges and let the CFTC approve hybrid products for futures exchanges, and I believe we will see that the ingenuity and variety of new instruments will enhance and enrich our capital markets.

S. 207 also has the potential to dramatically impact the swaps market. The same fundamental problem created by the exemptive authority for hybrids flows through the exemptive authority that S.207 grants the CFTC in dealing with the swaps markets and even some banking products, such as demand deposits. Swaps and banking products have never before been subject to the regulation of the CFTC or dependent for their continued existence on an exemption from the CFTC. There is no doubt in my mind that the CFTC has tremendous institutional experience regulating the futures markets and in exercising reasoned and sound judgement over the areas under their existing authority. But, I do not believe that expertise extends to the swaps or banking industries, nor do I believe there is any logic in doing so.

Finally, the limitations of S.207 on Index Participations ("IPs") lack any grounding at all in logic. The bill would deem all index participations to be futures and then would exempt from CFTC regulation only the eight IPs that were approved or pending before December 31, 1991. There are three fundamental problems with this: First, three of the "grandfathered" IPs are based on the S&P 500 index. S&P has an exclusive licensing agreement for S&P 500 futures with the Chicago Mercantile Exchange. Thus, if an IP is defined as a future, an IP on the S&P cannot trade. Second, all non-grandfathered IPs proposed by any other securities exchanges or based upon any other indices would be prohibited. The logic of this escapes me. If it is good for the public to be able to trade an IP at the AMEX, why not also at the Pacific Stock Exchange? If it is in the public interest to allow trading of an IP based on a grandfathered index, such as the NYSE Composite, why isn't it equally in the public interest to allow trading of an IP on other indexes, such as the Value Line Average or the Nikkei? Third, it is unclear whether the legislation would permit any modifications to the grandfathered IPs. These are not results driven by solid, reasoned public policy but rather by political compromise grounded in protectionism. The public is clearly the loser as it is deprived of the ability to trade IPs. I believe a better result would be to exempt all index participations from CFTC regulation.

This Committee, the SEC and the CFTC share a deep and abiding interest in maintaining the efficiency, soundness and competitiveness of the US markets for futures and securities. These provisions, however well intentioned, do not achieve those purposes and indeed will handicap our markets far into the future. It is vitally important that the full significance and potential impact of this bill be understood before it becomes law. Hearings should be held to analyze these issues and enable the Congress to explore fully the ramifications of this bill. Once done, I am certain that we will see that some basic changes need to be made to Title III in order to best serve the public interest. In any event, the SEC stands ready, as always, to work with you to develop alternative solutions to the problems created by the exclusivity clause.

Sincerely,

Mary L. Schapiro

Mary L. Schapiro
Commissioner

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

March 27, 1991

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

Thank you for your recent letter requesting my views on Title III of S.207, the Futures Trading Practices Act, as reported out of the Senate Agriculture Committee. In that letter you ask several specific questions about the regulation of hybrid instruments, including swaps, prescribed by the bill. I would like to focus on those matters on which I believe I can be of most assistance to you and give special attention to the treatment of swaps and deposits.

As I have noted in testimony and previous correspondence on these issues, various problems arise from a basic principle underlying the current approach to the implementation of the Commodity Exchange Act (CEA), under which instruments with elements of futurity may be considered to be futures contracts and therefore required to be traded on futures exchanges. This approach has led to confusion in financial markets and involvement of the courts, of which the situation involving index participations is a good example. The developers of new financial instruments--including risk-shifting products--are responding to perceived economic needs, but the uncertainty about the treatment of new financial instruments in the United States under the CEA tends to discourage such efforts and to give an edge to financial centers abroad.

Clearly, these provisions of the CEA are in need of repair, and I commend the Senate for seeking to make needed changes. However, as I indicated previously, the approach taken by S.207 will continue to preserve impediments to innovation in hybrids and risk-management products and may well forestall developments in swap markets that could reduce systemic risk. The 50 percent value test embodied in the bill is arbitrary, as will be any procedure for determining the value of the commodity component of a financial instrument, and could yield anomalous results for similarly structured instruments. The exemptive authority given to the Commodities Futures Trading Commission (CFTC) under this bill is narrow and in some cases would prohibit the Commission from making appropriate exemptions. The hearing requirement could lead to a

cumbersome exemptive process which itself would pose an obstacle to innovation. Further, the use of regulatory exemptions, once granted, itself creates uncertainty, as they may be revoked at a future date.

Instead of this approach, which seeks to exempt certain hybrids from the CEA, it would be preferable, as I have noted previously, to allow such instruments to trade on markets selected by the parties. Thus, equity-related derivative products could trade on either securities or futures exchanges and banks and other financial institutions could offer commodity derivative products where appropriate prudential and investor protection safeguards are in place. In this way, owing to different customer bases, similar products could evolve in ways that best meet the needs of those customers.

In the case of the swap markets, I am concerned not only about the potential adverse effects of S.207 on competition and innovation but also about its potential to impede the development of netting arrangements designed to reduce counterparty credit risks and, therefore, systemic risks in the financial markets. Last November, the Governors of the central banks of the Group of Ten countries released a report that concluded that netting arrangements, if properly designed, have the potential to reduce the size of credit and liquidity exposures incurred by participants in interbank and other wholesale financial markets, including the swap markets, and thereby contribute to the containment of systemic risk. However, the provision of S.207 that limits the exemptive authority of the CFTC to swap agreements that are "not designed to and would not result in a trading market in the swap agreement" could prevent the development within the United States of multilateral netting arrangements for swap obligations. Other conditions of this swap exemption authority may also result in a failure to exempt certain existing swap transactions. The enactment of these provisions could push multilateral netting arrangements for swap obligations and the swap markets themselves offshore.

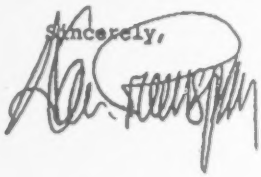
Proponents of the prohibition of multilateral netting of swap obligations have argued that such a system would, in effect, be a futures exchange and, therefore, should be subject to CFTC regulation. There are important differences, however, between a traditional futures exchange and the multilateral netting systems that have been developed in other financial markets. Participation in these netting systems generally is limited to commercial banks and other regulated financial institutions that traditionally have taken an approach to risk management that is fundamentally different from the approach used by futures exchanges. In designing multilateral netting systems, generally these institutions have adopted decentralized systems that preserve incentives for bilateral risk management (by allocating losses from a default in the first instance to the original counterparties of the defaulting participant) rather than adopting the centralized systems used in the futures industry that mutualize losses without regard to the original counterparties. For such decentralized systems, the regulatory framework developed by the CFTC for futures exchanges seems

inappropriate. The case for CFTC regulation is further reduced if those other systems are subject to regulation by another federal agency.

In addition to extending the coverage of the act to swap transactions, Title III also suggests that the CFTC will have jurisdiction over some depository instruments and lending transactions. We do not believe that it is appropriate for banking activities of federally regulated institutions to be subject to the jurisdiction of the CFTC. Banks are subject to a comprehensive system of federal regulation designed to ensure the safety of the institutions and to protect their customers; there is no need to impose another layer of regulation on their activities, especially where that regulation is designed to meet concerns that are not relevant to banking activities. Further, the bill could be read to preclude banking regulators from overseeing banking transactions that are exempted by the CFTC, a situation that would be inadvisable.

I hope you find these comments to be helpful.

Sincerely,



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

April 12, 1991

Dear Senator Wirth:

The Federal Deposit Insurance Corporation is pleased to comment on your proposed amendments to Title III of S. 207 as reported by the Committee on Agriculture, Nutrition, and Forestry.

As you know, we have reservations regarding portions of S. 207 as reported. Sections 302 and 303 contain provisions which affect financial institutions insured by the FDIC. These provisions generally would allow the Commodity Futures Trading Commission (CFTC) to regulate under the Commodity Exchange Act certain financial products, including certain swap agreements, deposit accounts, and hybrid instruments. In addition, section 302 would allow the CFTC to exempt such instruments from regulation if it determined that an exemption would be in the public interest.

Banks regulated by the FDIC and the other federal banking regulators currently operate under a comprehensive system of federal and state regulation designed to protect depositors and ensure the safety and soundness of insured institutions. We are concerned that S. 207 as reported would impose an additional unnecessary layer of federal regulation and supervision on depository institutions. We also are concerned that this additional layer of regulation could increase the cost of developing new banking products and services and stifle innovation in the industry.

As a consequence of our concerns, we support your proposed amendments to S. 207. Under your proposal, there is a simple exemption for deposits issued by federally insured depository institutions and certain foreign banks regulated under federal law. This statutory exemption will provide certainty, eliminate any confusion, and reduce an unnecessary layer of federal regulation. The FDIC is pleased to endorse your amendments.

With best wishes.

Sincerely,

L. William Seidman

L. William Seidman
Chairman

Honorable Timothy E. Wirth
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

March 15, 1991

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Riegle:

Last week the Senate Agriculture Committee marked up S. 207, the "Futures Trading Practices Act of 1991". The provisions of Title III of S. 207, entitled "Intermarket Coordination", are highly restrictive and seek fundamentally to restrain competition. Title III of S. 207 also contains provisions that would alter the basic jurisdiction of the Securities and Exchange Commission ("SEC") as it has existed, in large part, since enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. This letter presents my views on the effect that Title III would have, if enacted, on the jurisdiction of the SEC and, more broadly, on the competitiveness of U.S. securities markets.

The impact of this legislation would diminish the vitality and competitiveness of U.S. securities markets internationally. It would also weaken their ability to facilitate the raising of capital for U.S. businesses at the lowest possible cost. As a result of this codification of the most expansive possible interpretation of the commodities laws, most new innovative hybrid securities products, as well as an unknown number of banking products and swaps transactions would, in effect, become illegal if traded or sold anywhere other than on a futures exchange unless licensed or approved by the Commodities Futures Trading Commission ("CFTC"). New products would be barred from heretofore open and competitive markets unless market participants engaged in lengthy and expensive regulatory proceedings to prove to the CFTC that these products should be allowed to exist.

Purposes and Effects of Title III on SEC Jurisdiction

Under the language of sections 302, 303 and 304 of S. 207 as marked up, for the first time in history, trading in securities on the nation's securities exchanges would depend, by statute, on the affirmative action of an agency other than the SEC. For this reason, these provisions of S. 207 represent a fundamental and highly significant change to the nation's securities laws.

If enacted, this legislation could be read to transfer one of the SEC's most important and fundamental responsibilities, that of defining "securities," to the CFTC. As a result, the jurisdiction of the SEC would be permanently reduced, to the detriment of the SEC's ability to apply a coherent system of securities laws to future developments in the nation's capital markets.

S. 207 would also appear designed to transfer jurisdiction over index options products currently listed on the Chicago Board Options Exchange, American Stock Exchange, New York Stock Exchange, Philadelphia Stock Exchange and Pacific Stock Exchange (and perhaps even options on individual securities) to the CFTC. New section 4c(g)(B) of the Commodity Exchange Act ("CEA"), added by Section 303 of S. 207, specifies that any transaction "in or involving a commodity regulated under this Act ... shall be subject to regulation by the [CFTC]." Since stock indexes are treated as commodities for purposes of the agricultural laws, this provision appears designed to transfer regulation of the index options markets from the SEC to the CFTC. Trading in such index options last year exceeded $2.5 trillion, making them the largest derivative markets for U.S. equity securities. Oversight of the nation's options trading markets has been the exclusive function of the SEC since 1934.

Title III also subjects the very large and highly competitive swaps market, in which major U.S. banks and securities firms are principal participants along with U.S. corporations, to the agricultural laws of the United States under the jurisdiction of the Agriculture Committee. Similarly, S. 207 provides for exemptions from the CEA for many, though perhaps not all, "demand deposits, time deposits, or transaction accounts" within the meaning of the federal banking laws. By stipulating the conditions under which an exemption from the exclusivity clause of the CEA may be provided, S. 207 appears designed to create the impression that jurisdiction over these banking and securities products has been transferred, at least in part, to the CFTC.

Many provisions of Title III of S. 207 appear to have been drafted just before markup, without ever being the subject of hearings and without the participation of the SEC. The effects of these provisions, which would represent a very significant transfer of jurisdiction, may simply be the unintended consequences of hasty and ill-considered drafting. Nevertheless, they may do enormous damage to the securities, options and swap markets, which compete with futures exchanges, if the process moves too rapidly for thorough study of the effects of Title III.

Title III Is Not a "Compromise"

As you know, last year Senators Dodd, Heinz and Bond of the Banking Committee reached a compromise with Senators Leahy and

Lugar of the Agriculture Committee. The compromise concerned, among other things, the reforms necessary to curtail the flagrantly anticompetitive "exclusivity clause" of the CEA.

The staff of the SEC worked together with the staff of the Senate Banking and Agriculture Committees for literally hundreds of hours to perfect the necessary legislative language to implement this compromise. This language was formerly included in Title III of S. 207. The SEC testified in favor of this draft language in a hearing held before the Agriculture Committee on February 7, 1991.

At some point between the hearing on February 7 and the markup by the Agriculture Committee last week, the carefully developed compromise language of Title III was replaced completely by the current language of Title III of S. 207, which we understand was still being written during the night before markup. The SEC never testified concerning the new "midnight language", and we did not receive a copy of it until completion of the markup. Indeed, to my knowledge no hearing has ever been held in any committee of either the Senate or the House of Representatives to consider the impact of this language on the nation's securities, banking, swaps and other financial markets. Instead, apparently the future development of the American capital markets is to be governed by the agricultural laws of the United States without consideration whatever of the effect that this change may create.

Title III of S. 207 now represents no compromise at all. Rather, Title III will be read as codifying the most expansive imaginable application of the exclusivity clause. Ideally, those who have promoted the new language can come forward in the open and provide explanations for why it represents sound public policy. After public consideration of the impact of this legislation, Congress would be in a better position to determine whether to continue to allow the agricultural laws to be used to drive innovative new financial products out of the capital markets of the United States.

Problems with Title II

Moreover, Title II of S. 207, for the first time in history, would grant the CFTC jurisdiction over broker-dealers registered with the SEC under the Securities Exchange Act of 1934 where any such firm is affiliated with a futures commission merchant ("FCM"). Section 272 of Title II of S. 207 contains provisions designed to create holding company oversight over the affiliates of FCMs in a manner very similar to the authority granted to the SEC by Congress last year as part of the Market Reform Act initiated by the Committee on Banking, Housing and Urban Affairs. In the absence of any provisions that the rules and requirements of the CFTC applicable to the broker-dealer affiliates of FCMs would be

conformed to the pre-existing reporting obligations of broker-dealers to the SEC, enactment of Title II would impose substantial additional regulatory costs on securities firms.

The additional and possibly very substantial new regulatory costs that Title II would impose on securities firms would come at a time when earnings are under very great pressure, and when more than 60,000 jobs have been eliminated in the industry as a whole. Given that FCM subsidiaries of broker-dealer holding companies are typically trivial in size compared with their broker-dealer affiliates, and that holding company oversight already exists for such firms, it is not clear why broker-dealers or their holding company affiliates within the jurisdiction of the SEC should be subjected to such unnecessary regulatory controls and related expenses.

Conclusion

In the view of the SEC, it is bad public policy to severely restrict the flexibility of banks and securities firms to design new instruments to serve the financial needs of businesses across the United States as would occur under the provisions of S. 207. I personally believe that the needs of our markets should not be sacrificed to domestic protectionism for any group. Ideally, we should seek to strip away anticompetitive laws like the exclusivity clause, not strengthen and extend them.

At a minimum, however, any decision to so dramatically narrow the traditional functions of the SEC and the flexibility of our securities markets should only be made after public hearings and full consideration by the Committees with responsibility for the financial laws and markets of the United States. Indeed, this legislation would appear to render the reauthorization of the SEC later this year much less meaningful. Whatever you and the Committee can do to restore fairness and order to the legislative process with regard to these proposals so important to the securities laws and markets will be most appreciated.

Sincerely,

Richard C. Breeden
Chairman

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

March 21, 1991

The Honorable Patrick Leahy
Chairman
Committee on Agriculture, Nutrition,
and Forestry
United States Senate
Washington, D. C. 20510-6000

Dear Mr. Chairman:

Thank you for your letter of February 12, 1991 requesting comments on S. 207, the "Futures Trading Practices Act of 1991" (Bill). Your letter directs our attention to those provisions of the Bill that might affect financial institutions under the regulatory jurisdiction of the Office of the Comptroller of the Currency. Since receiving your letter, S. 207 underwent a mark-up by the full Committee, and our comments below are based upon the marked-up version.

Specifically, section 302 of the Bill would amend section 4 of the Commodity Exchange Act, 7 U.S.C. § 1 et seq., (CEA), to add subsections (c) and (d) to provide the CFTC with discretionary authority to exempt from the CEA certain agreements (Exemption Provisions). Included would be authority to exempt individually negotiated interbank contracts, swap agreements and deposits offered by banks, either individually or by classes of these instruments (collectively referred to herein as Bank Contracts), after notice and opportunity for hearing. The CFTC would be required to find that the grant of an exemption would not be "contrary to the public interest." In addition, the CFTC would be authorized to impose conditions on the grant of any exemption.

Our concerns with the Exemption Provisions of the Bill center on the belief that Bank Contracts are not subject to the jurisdiction of the CFTC. Primarily, we are concerned that the exemption authority may imply that the CFTC has regulatory authority over Bank Contracts. We believe this would create confusion as to the regulatory scheme applicable to Bank Contracts, resulting from the creation of the presumption that the CFTC could regulate such instruments, although it would not expressly have this power. In addition, we are concerned that any action which would inject the CFTC into the regulation of Bank Contracts would be nonproductive since banks are currently subject to substantial regulation.

We expressed our position that the CFTC has no power over Bank Contracts when the CFTC issued a proposed regulation concerning hybrid and related instruments (52 Federal Register 47022 (December 11, 1987)) (Proposed Rule). Under the Proposed Rule, the CFTC maintained it had jurisdiction to regulate Bank Contracts on the theory of the "economic equivalence" of these instruments to futures or options. We objected to the proposed rulemaking, and expressed policy concerns over possible disruption of the financial markets and the furnishing of banking products that are well-regulated by banking regulators. The CFTC and its staff addressed the concerns we and other bank regulators raised regarding the proposed rule and the regulatory problems encountered regarding new financial products that combine elements of futures or options contracts with debt or depository obligations. Considerable progress has been made in clarifying regulatory responsibilities since the publication of the Proposed Rule.

It is the OCC's view that, under existing law, swaps and deposits made within the purview of permissible banking activities are not contracts of sale for future delivery. A contract that does not cover potential future delivery of a commodity is neither a futures nor a forward contract under the CEA, and, therefore, is outside the regulatory scope of the CFTC.

By granting the CFTC exemption authority, the Bill might establish a presumption that a bank's individually negotiated Bank Contracts are contracts of sale for future delivery, subject to regulation by the CFTC. Confusion regarding the regulatory status of financial instruments could follow since a presumption that the CFTC possessed regulatory authority, created by implication, would not necessarily mean that the CFTC would have jurisdiction over Bank Contracts. Thus, financial markets might be uncertain as to the regulatory scheme to which these instruments would be subject. If this were the case, banks desiring to offer products of this sort would encounter substantial additional legal costs in connection with the development of these products. This result could substantially inhibit incentives for the development of creative bank products.

We note that the Exemption Provisions could have the effect of excluding Bank Contracts from the CEA, if the CFTC so chose. However, it is not certain that any exemptions granted by the CFTC would be unconditional. A conditional exemption could have the effect of subjecting Bank Contracts to the same additional layers of regulation to which they would be subject if they were not exempt from the CEA.

Y[illegible] letter mentions the concern expressed by some that should [illegible]CFTC exempt swaps and the other specified products from the CEA; such action might result in trading in an environment lacking appropriate safeguards, thus posing a threat to financial

institutions and the public. As indicated above, we believe that with respect to Bank Contracts, appropriate regulatory authority already exists under banking laws. Moreover, involvement of the CFTC in the regulation of Bank Contracts might inhibit their development, along with the potential benefits they bring to financial institutions and the public.

We recognize the legitimate concerns of the CFTC to examine closely the regulation of products with characteristics of options and futures. Similarly, the CFTC has recognized the legitimacy of the OCC's supervisory responsibility for, and authority over, national banks. Because Bank Contracts are currently subject to extensive supervision, there is no need to subject banks to additional layers of regulation, administered by non-bank regulators. As banks develop new products, other than Bank Contracts, with characteristics that mirror those offered by other financial market participants, however, it will be appropriate to consider how to regulate those products. There must be opportunities for consultation and cooperation. Finally, it will be important to ensure that regulatory authority is allocated in a manner that does not result in unwarranted overlapping regulation, which could cause needless disruption of healthy markets and stifle innovation.

[ery much appreciate the opportunity to provide you with our [ents. Please let me know if I can provide any additional information.

Sincerely yours,

Robert Brigerino
Acting Chief Counsel

DANIEL L. GOELZER, ESQUIRE
EDWARD F. GREENE, ESQUIRE
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April 5, 1991

The Honorable Donald W. Riegle, Jr., Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Title III to S. 207

Dear Senator Riegle:

The undersigned are former Generals Counsel of the Securities and Exchange Commission (the "SEC"). We write, not in any official capacity, nor on behalf of any client, but solely in the public interest, to express our strongly-held view that *Title III to S. 207 should not be enacted in its present form;* instead, we urge that *Title III should be modified* to avoid the internecine regulatory battles that prompted its drafting and that will ensue long after the legislative debate over S. 207 has ended if the bill were enacted in its present form.

Entitled "Intermarket Coordination," Title III attempts to define, among other things, the respective jurisdictions of the Commodity Futures Trading Commission (the "CFTC") and the SEC with respect to a new generation of financial instruments, not comprehended by either the legislation pursuant to which the CFTC was created nearly twenty years ago, or the organic statutes that launched the SEC nearly six decades ago. The financial instruments that would be affected by Title III are often referred to as "hybrid instruments," because they combine some or all of the characteristics of traditional securities (such as equity and debt instruments currently traded on organized securities markets) and some or all of the characteristics of futures-related contracts (such as those currently traded on designated contract markets).

There is no dispute about the need for legislation. Because current law does not comprehend these hybrid instruments, and the many forms of instruments that surely will evolve in our financial markets over the coming years, the important task of setting policy initiatives for our financial markets has been relegated to the judiciary, the branch of government most ill-equipped to fashion a regulatory framework for the future. That is the function of the Congress, and one that the Congress should insist on performing itself. The courts are limited when confronted with the question whether a particular instrument should be regulated either as a security, or as a commodity futures contract, and must apply *existing* law to instruments existing law never envisioned. The result to date has been a patchwork quilt of hastily-devised compromises, constant litigation, conflicting legal views about the ability of both the CFTC and the SEC to regulate the financial markets, unseemly regulatory competition, and, most importantly, uncertainty for business men and women who cannot predict with any degree of certainty whether a particular instrument must be subjected to the regulatory scheme of the SEC or the regulatory scheme of the CFTC.

This problem has been prevalent since at least 1974, and might prompt one to inquire why a legislative solution is critical at this juncture. The answer, we believe, is relatively straightforward. In light of recent decisions, the courts apparently will apply a mechanistic test for determining where jurisdiction over a particular financial instrument lies — if there are *any* elements of a futures contract (a test so vague as to be dangerous, since it could, applied literally, reach equity securities), it is likely that the courts will enforce an "exclusivity" provision in the CFTC's enabling legislation to preclude SEC jurisdiction over the instrument. This test has been crafted not at the behest of the regulators, but at the behest of those who seek to prevent the development of new, and possibly competing, financial instruments.

The current state of the law, therefore, discourages innovative new financial products, given the high cost of litigation and the uncertainty of the outcome of such squabbles. Worse, this situation encourages those with ideas for new financial instruments to avoid United States jurisdiction altogether, since CFTC jurisdiction carries with it a requirement that any hybrid instrument be traded on a CFTC-designated contract market, whereas many of these instruments are not sufficiently standardized to warrant such trading, or to make such restrictions palatable. The result is simply that *no* regulation of these instruments will exist, and the United States will be the worse off. Congress' policy goals — the effective regulation of securities and commodity futures contracts — will be thwarted. Only an amendment to existing law can accomplish this goal.

As currently drafted, however, Title III would vest "exclusive jurisdiction" in the CFTC over any hybrid instrument if at least fifty percent of its overall value was related somehow to commodity futures. In addition, Title III would subject some, but not all, index participations ("IP") to the exclusive jurisdiction of the CFTC. In our view, these provisions represent an ill-advised continuation of the very same *ad hoc* approach utilized in the past

that has made the resolution of the regulatory fragmentation so intractable in the first instance.

While Title III recognizes that hybrid instruments, by their very nature, may implicate both the securities and commodity futures regulatory schemes, its provisions ignore the legitimate interests that both the SEC and the CFTC may have in such instruments by vesting exclusive jurisdiction in *either* one agency *or* the other. Rather than establish a framework in which the fundamental objectives of both regulatory schemes can coexist and interact, Title III would impose on issuers, financial markets and market participants an arbitrary fifty percent value test. Under Title III, if forty-nine percent of an instrument's overall value is somehow related to a commodity, it may trade freely without CFTC oversight. If, however, an additional one percent of its overall value is related (in ways undefined at present) to a commodity, the instrument would be permitted to trade only on a designated contract market or not at all. We find it inexplicable how this one percent increase could so jeopardize the fundamental objectives of the CFTC's regulatory framework so as to justify such radically anomalous results.

Title III applies this same arbitrary treatment to index participations — whether an IP is permitted to trade on a securities exchange depends, in effect, solely on whether the securities exchange in question had the necessary clairvoyance to seek early SEC approval for the IP offered by that exchange. Under Title III, securities exchanges which lacked the requisite foresight would be forever precluded from trading IPs, and those permitted to do so would be forever precluded from modifying those instruments for the benefit of investors. If IPs do not affect adversely the fundamental objectives of the CEA — a proposition which Title III explicitly endorses by permitting IPs to trade on securities exchanges — then all IPs should be permitted to trade irrespective of the date they were, or are, approved.

Title III also fails to provide the predictability required by rational business executives. Under Title III's value test, the valuation is determined at the date of issuance. In a typical underwritten offering of securities, however, the offering generally is priced, and the underwriting agreement signed, prior to the date of issuance. Hence, an instrument excluded from CFTC jurisdiction when priced, may well turn out to be within the CFTC's jurisdiction when issued.

Moreover, the application of Title III's value test may result in disparate treatment of the same or nearly identical hybrid instruments. By way of illustration, an instrument or transaction which might not have been subject to exclusive CFTC jurisdiction on the day it was first issued may become subject to CFTC jurisdiction upon a subsequent issuance of the same instrument because of unanticipated volatility in the related commodity. Likewise, within the same day, a hybrid instrument may be within the jurisdiction of the CFTC, while another hybrid instrument, structured in the identical manner, may be excluded from CFTC jurisdiction merely because it is linked to a different commodity.

Historically, the regulation of financial instruments has struck a balance between the protection of investors and market participants on the one side, and the freedom to offer innovative and beneficial products on the other. Title III ignores, rather than strikes, that balance. Title III would continue to prohibit vehicles designed for *bona fide* corporate purposes simply because they contain elements of futurity; notwithstanding the fact that comparable investor protections are in place under another regulatory scheme, or the fact that the designated contract markets on which they would be required to trade simply cannot accommodate such issuer-specific instruments. Under such circumstances, it seems only logical to permit the capital formation and investment process to be conducted under the regulatory scheme designed precisely for that purpose.

Today, world class issuers may choose many markets in which to finance. Because of competition, intermediaries throughout the world are constantly developing new products. To the extent the products have a hybrid quality to permit investors and companies to hedge against interest risk, currency risk and commodity prices, a question arises as to the applicable regulatory regime in the United States. Unfortunately, there is often a question as to whether these products are subject not only to the federal securities laws but also to the CEA if sold in the United States. If the product is subject to the CEA, it is simply not sold n the United States or to U.S. persons because of the time it would take to obtain approval. The structure of the CEA envisages that all future products — pork bellies to Government securities — must first be approved in advance for trading and then may only trade on an exchange unless certain narrow exceptions apply. Hybrid products are developed to be offered and sold in international capital markets generally to take advantage of changing market opportunities. Because of rapidly changing market conditions, they should be regulated as securities, relying upon full disclosure to investors of the appropriate terms.

There is no doubt that the exclusivity provision of the CEA, the CFTC assertion of jurisdiction over hybrid securities, and the fact that any new product is required to go through an approval process before it could come to the market means that the Euromarket and other international markets will continue to develop products for issuers, many of which will not be offered or sold in the United States, and the U.S. market will be limited to those products which the CFTC exempts from the CEA. If we are right, the CFTC will decide what new instruments may be sold in the securities markets, and the CFTC may be under pressure for competitive reasons to limit the number of products which may be sold and traded other than on a commodities exchange. Thus, we will see in the United States only those instruments where the value of the option and future component is less than 50% as determined by the CFTC. The rest of the world — but not the United States — will see whatever instruments investors find attractive.

Finally, Title III fails to provide a long-term solution to our fragmented regulatory structure. It applies an instrument-by-instrument paradigm that addresses only the immediate problem, and that ultimately will fail to address the next generation of financial instruments.

In our view, any legislative remedy that is to serve the public interest and strengthen U.S. financial markets must encompass certain fundamental principles. First and foremost, we believe that the fundamental objectives of the CEA and the federal securities laws remain valid today. Accordingly, any legislative remedy must permit the CFTC and the SEC to exercise and apply the minimal objectives of their respective regulatory schemes, if and as appropriate, while avoiding unnecessary and duplicative regulation. Second, a legislative remedy must provide predictability as to what rules and regulations will apply. Uncertainty is the bane of business. It eliminates market activity, discourages innovation and increases costs. Third, a legislative remedy must encourage competition — competition that will spur the development of innovative and beneficial products for U.S. financial markets at a reduced cost. Fourth, any legislative remedy must take into account the globalization of the futures and securities markets and the fact that beneficial instruments not permitted to trade in the United States will be traded elsewhere. Finally, any legislative remedy must provide a long term, rather than a piecemeal, solution.

We believe that an appropriate and mutually agreeable solution can be crafted that will embrace these fundamental goals. There are at least several readily available solutions that will resolve the current regulatory fragmentation, without generating the significant dislocations for U.S. financial markets, their participants, and investors that would be caused by the Congress' adoption of Title III. Certain of these legislative alternatives are outlined in our accompanying submission, and we are available to discuss those, and other possible solutions, with the Members of the Congress.

In all events, no amendment to the CEA should be adopted unless it is clear that the solution selected is the one best suited to encompass those fundamental principles which we believe have stood, and will continue to stand, the test of time. Such an assessment requires the type of development and analysis, both economic and legal, that only is forthcoming in full public debate, where all views may be aired and carefully considered.

For all of these reasons, we urge the Congress to reject Title III to S. 207 as presently drafted, and to amend the CEA to remove the rigid barriers, unforeseen and unintended, that have arisen to impede the development of new and useful products that further legitimate business purposes and diminish the global competitiveness of the United States.

Sincerely,

Daniel L. Goelzer Edward F. Greene Harvey L. Pitt

AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C.
20036

EXECUTIVE DIRECTOR
GOVERNMENT RELATIONS
Edward L. Yingling
202/663-5328

March 22, 1991

The Honorable Donald W. Riegle, Jr.
United States Senate
Washington, D.C. 20510

Dear Senator Riegle:

The American Bankers Association ("ABA") wishes to express its strong concerns with the Futures Trading Practices Act (S. 207), as reported by the Senate Agriculture Committee. In particular, the ABA is extremely concerned about the detrimental impact that Section 302 covering exemptive authority and Section 303 governing hybrid commodity instruments may have on the development of new financial products. In large part, these Sections seek to extend the jurisdiction under the Commodity Exchange Act ("CEA") of the Commodity Futures Trading Commission ("CFTC") over certain financial products. In our view, no need exists for the CFTC to regulate certain types of swap agreements, deposit accounts and hybrid instruments since they are either subject to regulation by federal and state banking authorities or do not have sufficient indicia of futurity to require CFTC regulation. The ABA is concerned that the manner in which these provisions have been drafted will have potentially wide ranging and undesirable effects on a vast array of existing and new financial products that may be offered outside of future exchanges. For example, as the bill is currently drafted, any financial product, including a deposit account, that does not satisfy all the enumerated prerequisites for exemption would be subject to CFTC jurisdiction. Given this potential for expensive and duplicative regulation by the CFTC of these deposit instruments, banking institutions will be reluctant to develop new and innovative products to suit the financial needs of their customers.

From a policy point of view, extending the jurisdiction of the CEA to require futures exchange trading for swap agreements, deposit accounts and hybrid instruments is both unnecessary and burdensome. Swap agreements are not offered to the public and financial institutions and securities firms, participants in the swap market, are currently subject to federal oversight and protection. Deposit accounts, while offered to the public, are also subject to comprehensive regulation by federal and state banking regulators. Hybrid instruments, to the extent they are

structured as depository instruments, are similarly subject to comprehensive federal and state banking regulation.

Consequently, it is the ABA's position that these instruments, to the extent they are subject to federal or state banking regulator oversight or are not offered to the general public, should be expressly excluded from CFTC jurisdiction. The ABA is confident that any such exclusion could be drafted to ensure that the public interest is adequately protected.

The ABA would note that it would not support in any manner the total elimination of these provisions from the bill. Rather the ABA believes that the CEA should be clarified to exclude bank products currently subject to federal and state regulation from duplicative and potentially inconsistent regulation by the CFTC.

For example, an exclusion could be drafted for deposit accounts by removing current paragraph (d)(2) to Section 302 and, instead, inserting the following language in Section 2 of the CEA:

> "This Act shall not apply to any demand deposit, time deposit, or transaction account (as defined in subsections (b)(1), or (c)(1), and (e) respectively, of Section 204.2 of Title 12, Code of Federal Regulations) subject to regulation by an appropriate federal banking agency."

This exclusion would ensure that new product development would not be stifled because duplicative and burdensome regulatory requirements would not be superimposed on existing bank regulation governing deposit accounts. Moreover, concerns that these instruments could escape any federal oversight would be avoided as the exclusion would be predicated on the deposit account being subject to federal or state banking regulation.

We appreciate the opportunity to express our concerns regarding Title III of S. 207. The ABA staff will be pleased to work with you and your staff to address these important issues for the banking industry.

Sincerely,

Edward L. Yingling

SECURITIES INDUSTRY ASSOCIATION

WASHINGTON OFFICE 1850 M Street, N.W., Washington, D.C. 20036 (202) 296-9410

Chairman, 1991 Board of Directors

April 8, 1991

The Honorable Christopher Dodd
Chairman, Subcommittee on Securities
534 Senate Dirksen Office Building
Washington, DC 20510

Dear Senator Dodd:

SIA is pleased to respond to your letter of March 28, 1991, to express our views on Title III of S.207, The Futures Trading Practices Act, as reported by the Senate Agriculture Committee. As you are aware, SIA has had a longstanding interest and involvement in many of the issues raised by this title. SIA strongly believes that both the general objectives and specific provisions of Title III as reported out by the Agriculture Committee are deeply flawed.

First, you asked about the uses of, and markets for swaps and hybrid securities. Hybrid products and swaps are innovative new financial products that are vital for clients to manage risk and uncertainty in an increasingly risky and uncertain environment. Effective risk management aids the capital-raising process, thus improving long-term investment as well as economic growth for our nation. Moreover, effective risk management in the financial markets helps to promote safety and soundness of the entire financial system, as well as restore confidence in our markets. Any legislation affecting swaps and/or hybrid products should therefore enhance the capital-raising process by reducing uncertainty, encouraging further innovation and preserving the efficiency and international competitiveness of these products and markets. Unfortunately, we strongly believe that the provisions concerning swaps and hybrids (Sections 302 and 303) of S.207 as reported will in fact undermine these very objectives that we all believe are so critically important. Before describing the specific problems created by these provisions as reported, we offer a brief chronology of SIA's interest and involvement in the evolution of this legislation.

Following the 1987 market break and the report of the Presidential Task Force on Market Mechanisms ("Task Force") chaired by now Secretary of the Treasury Nicholas F. Brady, SIA endorsed the major recommendations of the Task Force, including calls for one principal regulator to coordinate the critical regulatory issues which affect related market segments throughout the financial system, as well as one unified consistent margin-setting authority for functionally related products such as stocks, stock options and stock index futures. The Task Force and SIA also endorsed coordinated circuit breakers for the equity and equity-related markets.

After the 1989 "mini-crash," SIA again supported these and other proposals and made further recommendations to help curb the unsettling bursts of severe intraday volatility affecting the equity markets. The Administration's "Capital Markets Competitiveness, Stability and Fairness Act" (S.2814), introduced last Congress, addressed virtually all of the recommendations made by SIA and received our strong support. SIA testified in support of the legislation in both the Senate and the House.[1]

The compromise drafted at the end of the 101st Congress, under your leadership, along with Senators Bond, Leahy and Lugar also addressed a number of important recommendations made by SIA, particularly the margin and coordinated circuit breaker proposals. However, it did not contain any language relating to the issue of jurisdiction over stock index futures which was of vital importance to SIA. Nonetheless, in testimony before the Agriculture Committee earlier this year, SIA testified that the proposed compromise in the last Congress was an important first step in rationalizing the regulation of our capital markets. It was acceptable to SIA as far as it went, but we testified that it did not go far enough because it did not address the jurisdiction issue.

Swaps

The swaps provision of the original S.207 was by and large satisfactory to SIA. While we had some qualms about the language concerning hybrids, it was generally unobjectionable, since it would have left our capital markets free to innovate and compete.

Title III of S.207 as reported by the Agriculture Committee radically alters most of the key elements of that compromise. Oversight authority over margins would be granted to the Federal Reserve Board, but it could immediately delegate that authority to the CFTC without the 30-month trial period for Fed margin control envisioned by the original compromise in S.207 as introduced.

[1] testimony of Edward I. O'Brien, President of SIA, before the House Subcommittee on Telecommunications and Finance, May 3, 1990; testimony of John Bachmann, past Chairman of SIA, before the Senate Banking Committee, July 11, 1990; and testimony of Marc Lackritz, Executive Vice President, SIA, before the Senate Agriculture Committee, February 20, 1991.

Particularly great damage was done to the original thrust of the bill by the changes made to the swaps provision of the legislation. The new section lacks the clarity and objectivity required to enable U.S. participants to conduct swaps business in the United States and to compete in the international marketplace. It is particularly troubling that this provision, which was originally intended to create a workable exception for swaps free of many of the limiting provisions of the CFTC's 1989 Policy Statement Concerning Swap Transactions, is instead significantly more restrictive than the Policy Statement.

As reported, S.207's swaps provisions are in two parts. Both parts rely on the definition of swap agreements set forth in the Bankruptcy Code as well as in S.207 as introduced. The first part (proposed 4 (d)(1) of the CEA) provides for exclusion from the CEA for certain qualifying swap agreements. The second part (proposed 4 (d)(2)) mandates the CFTC to issue an exemption for certain other swap agreements under specified conditions. Both parts as drafted would undermine the existing swaps market and business by greatly increasing uncertainty and risk. Moreover, the existence of both an exclusion and exception may be read to create a negative inference insofar as excluded swaps would not be deemed to be futures contracts; whereas conceivably, exempted items might be.

The exclusion may well be intended to provide greater certainty, but the limitations on the exclusion dramatically undermine its effectiveness and, in fact, create vastly more uncertainty. The exclusion as written is so narrow as to define an illusory set of transactions. To be eligible for exclusion, the swap agreement must meet two criteria. The first is that "each party enters into the swap agreement to hedge or manage a business-related price risk." This criterion, which is significantly more restrictive than the Policy Statement's "line of business" test, ignores the nature of the market, making the exclusion unavailable to swap dealers (those banks, securities firms, and others whose business it is to offer swaps and manage the resulting interest rate or commodity price risk). Instead, this criterion would only apply when swaps are entered into between "end users" who are hedging or managing other business risks. The swaps business doesn't operate this way - swaps intermediaries (brokers and dealers) are integral to the operation of the market because the credit facilitation provided by intermediaries is necessary for,the transactions to occur.

The second criterion necessary for the exclusion is that "each party reasonably expects to perform fully its obligations to make or receive payments at the time or times specified in the swap agreement." This provision requires an uncertain subjective evaluation of the intent of the parties entering into the swap. The criterion is intended to preclude termination and netting, two important risk reduction techniques that are encouraged by bank regulatory authorities. It will also hurt the competitiveness of U.S. firms by making them unattractive counterparties for the many participants, particularly non-U.S. banks and securities firms, who will be reluctant to provide any such certification as to their subjective intent.

The second part of the swaps proposal directs the Commission to exempt certain swap agreements. However, unlike S.207, which included a mandatory provision requiring the CFTC to exempt swaps from all of the provisions of the CEA, the CFTC's proposal requires no exemption at all, but instead gives the CFTC discretion to exempt swap agreements "from any or all of the prohibitions and requirements" of the CEA. In addition, S.207 as reported contains three substantive requirements for exemption not contained in S.207 as introduced or the CFTC's Policy Statement.

The first requirement for exemption is that "each party to the swap agreement is an institutional participant" as defined elsewhere in the proposal to include certain financial institutions and corporations with net worth greater than $1 million. This requirement, while perhaps intended to be broad (since it includes registered floor brokers and floor traders), is generally very limited. Corporations and others must have net worth exceeding $1 million. Nowhere else in the world is it necessary to receive proof of a counterparty's net worth, evidence of which may not always be available or understood. Even if guaranteed by substantial companies or supported by other credit enhancements, corporations with less than $1 million of net worth would not be eligible. In addition, quasi-governmental entities like the IMF or the World Bank would not be eligible. Thus, the "discretionary exemption" would exclude many current participants in the market. Further, this $1 million net worth requirement would preclude insolvent companies and those in Chapter 11 bankruptcy or in workout situations from utilizing the swaps market to hedge their risks.

The second criterion for exemption requires that "the creditworthiness of each party to the swap agreement would be a material term of the negotiation of the swap agreement." While the CFTC's explanatory statement indicates that this provision is not intended to prohibit margin or collateral provisions, the criterion would appear on its face to embody a strict (if undefined) limit on such provisions. As a result, its intent is unclear. The criterion is also far too subjective to be workable and it is not clear whether it applies to the parties' master agreement or to each transaction under the master. In addition, the applicability of the section to options, where creditworthiness does not apply to the premium payor or to swaps with option features, such as caps and floors, is particularly unclear. Then too, where each side of a swap is a triple A credit, creditworthiness may not in fact be a negotiated term. The last criterion for exemption requires that "the swap agreement is not designed to and would not result in a trading market in the swap agreement." The term "trading market" is not defined. On its face, it would appear to prohibit completely a swap dealer from engaging in its customary business of making a market in swaps.

The overall effect of S.207 as reported is that it creates confusion and uncertainty. Swap participants will be inclined to do business outside of the U.S. rather than answer intrusive questions about their business and face the uncertainty of their

counterparty's eligibility under the CFTC's criteria. The imposition of congressionally mandated new and extraordinary requirements on swap participants creates new regulatory responsibilities for the CFTC and defeats the intent of the original framers of S.207, who sought a statutory amendment on swaps to provide clarity and certainty for international and domestic participants.

We note for the record that some have called for an express exclusion for bank deposit account swaps and hybrid products structured as depository instruments. We are troubled by this primarily because of the negative inferences that might be drawn were certain types of products to be automatically excluded from the CEA, while others would have to rely on the exemption process. This could unnecessarily and unintentionally harm non-bank deposit products and the firms that engage in that type of swaps business.

Hybrids and Exclusivity

The hybrid and exclusivity portions of S.207 as reported (Sec. 303) raise serious questions about the ability of American capital markets to compete in the future. The United States has traditionally had the broadest, most liquid, and most innovative capital markets in the world. After the imbroglio over the ambit of the CEA developed around the IPs products, a principal purpose of Title III was to resolve questions over hybrids and exclusivity which threatened to drive new product trading and development overseas. The original compromise contained in S.207 as introduced, while imperfect, did at least resolve some of the legal ambiguities and uncertainty inherent in the status quo.

Here too, the new language in S.207 as reported is a radical step backwards in a dramatic change from the original compromise. As reported, S.207 codifies into law the position that all financial instruments that the CFTC determines to include any degree of "futurity" must be traded on futures exchanges unless a product (1) meets a misleading mathematical test that less than 50% of its value derives from the value of the commodity option or future commodities prices or (2) receives a written exemption from the Commodity Exchange Act from the CFTC.

Even that apparently "neutral" 50% of the value test would likely provide no real relief since the test would be determined by the CFTC, and under the existing CFTC analysis, new equity products with characteristics of both futures and securities are always viewed as futures. Thus, it is highly unlikely that there would ever be an equity related hybrid that the CFTC would determine meets the requirement for the 50% exception. Moreover, the descriptive language accompanying the ostensibly clear value test is very murky and would lend little or none of the certainty promised by the numerical standard. Ultimately what is a hybrid remains unclear given the overly broad reach of the defining language.

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Were this provision to pass unchanged, a number of deleterious results would ensue. Innovation in American securities markets could be stifled; all hybrids having any element of futurity could be subject to regulation by the CFTC; issuers would bear the heavy burden of proving numerous factors to the CFTC. Exemptions (if granted) could be revoked; the exemptive process itself takes too long as it calls for a hearing with all of its cumbersome procedures and delays . Specifically, hybrid products with embedded futures would have to pass muster in an exemptive process that may well be too narrow to accommodate them. Issuers would still be subject to suits based on competitive considerations, thus chilling competition among securities and futures exchanges. American markets would thus remain at a competitive disadvantage in this area.

The process of raising capital could be inhibited by the costs of potential litigation, or even driven to overseas markets. The confusion and uncertainty that the original compromise was designed to reduce or eliminate would only be exacerbated by the additional court challenges that would inevitably ensue.

The reported legislation has additional unfavorable aspects which make its modification imperative. The SEC's ability to define a security is called into question by the legislation. For example, it could be read to give the CFTC jurisdiction over stock index options, other equity index products and perhaps, options on individual securities. Contrast this with the original Administration bill in the last Congress, S. 2814, which was intended to stimulate competition and innovation wherever possible. The current language seems designed to move in precisely the opposite direction by restricting innovation and competition in a series of existing and future products.

The exclusivity definition codified by S.207 as reported is strengthened in its application to banking, securities and other financial instruments. That expansive definition of exclusivity is subject only to the occasional exceptions or exemptions granted at the sole discretion of the CFTC. Many new hybrid securities products would, like index participations, be effectively banned or driven offshore. Arguably, jurisdiction over the entire index option market could be transferred to the CFTC. The net result of these rewritten provisions might well be to stifle precisely the increased competition and innovation critical to future economic growth and prosperity. Whenever possible our laws should allow securities and futures instruments to be offered to investors free of unnecessary restrictions. Low cost capital can be achieved only by minimizing regulatory hurdles, litigation and uncertainty as to the lawfulness of innovative forms of securities and futures instruments.

Despite seemingly broad exemptive authority, a financial innovator would have to meet the heavy burdens of proving at least five factors "to the satisfaction of the CFTC." One of the factors could even be read to give the commodities exchange a near veto over the exemption process by requiring that there be no material adverse effect on a future exchange's performance of self regulatory duties.

SIA has worked long and hard on the panoply of issues in this very complex and crucial area. We are deeply troubled that the result of all the effort to date is a measure we regard as destructive of the swaps market and injurious to the United States capital markets as a whole. We stand ready and eager to work with you, your colleagues, and staff to correct the inadequacies in the legislation.

Thank you for your consideration of our views.

Sincerely

Gedale B. Horowitz
Chairman

0288F

11 Wall Street
New York, NY 10005
212 656 4100
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William H. Donaldson
Chairman and
Chief Executive Officer

NYSE
New York
Stock Exchange, Inc.

April 8, 1991

The Honorable Donald W. Riegle, Jr.
United States Senate
Washington, DC 20510-2201

Dear Senator Riegle:

The New York Stock Exchange has reviewed the drafts of the proposed amendments to Title III of S207 as proposed by the Treasury Department, the Commodities Futures Trading Commission and the Securities and Exchange Commission.

The amendments to Title III regarding the establishment of margin requirements represent a vast improvement over existing law and we support these amendments. We wish to express our appreciation to the Treasury Department for their efforts in developing these new margin provisions.

With regard to those provisions of Title III dealing with the exclusive jurisdiction of certain trading instruments, we believe that the proposed language falls short of the Treasury Department's original proposals. We have consistently supported those original proposals.

We recognize that the Treasury Department and the Commodities Futures Trading Commission have put much effort into reaching the proposed compromise on jurisdiction. However, we feel that the alternative language proposed by the Securities and Exchange Commission, which parallels that originally proposed by the Treasury Department, would allow for a free competition among products of similar characteristics.

For that reason, we support the language proposed by the Securities and Exchange Commission and urge that it be incorporated in the final legislation.

Sincerely,

Bill Donaldson

86 Trinity Place
New York, New York 10006-1881
212 306-1100

James R. Jones
Chairman of the Board

American
Stock Exchange

March 20, 1991

The Honorable Donald W. Riegle, Jr.
U.S. Senate
Washington, D.C. 20510

Dear Don:

Last week the Senate Agriculture Committee filed its report on S.207, the Futures Trading Practices Act of 1991. While reauthorizing the CFTC and making needed changes in futures trading practices, the bill also contains language which does great harm to capital formation and U.S. competitiveness. While on the surface the language appears technical in nature, it actually serves to prohibit trading many financial instruments on any U.S. exchange.

Based on my fourteen years in Congress, I know members appreciate a complete airing of questions surrounding a piece of legislation before they vote on it. While I would not presume to ask for your support before a thorough review of the questions surrounding this bill, I would certainly appreciate the opportunity to bring you up to date prior to any floor consideration.

After reviewing the legislative language, it is clear that many of the most innovative capital formation tools of the past several years are threatened by the bill. The statutory language is so clear in many areas that report language cannot resolve misinterpretations -- the bill language itself must be rewritten to resolve uncertainties threatening these products.

I am in the process of putting together a more thorough letter outlining the ramifications of the bill as I see them. In the meantime, I hope the Senate will not act precipitously on S.207.

With thanks for your consideration.

Sincerely yours,

James R. Jones

AMEX

1776 G Street, N.W.
P.O. Box 37347
Washington, D.C. 20013-7347

Freddie Mac

April 8, 1991

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This letter is to provide you with the views of the Federal Home Loan Mortgage Corporation ("Freddie Mac") on S.207, a proposed amendment to the Futures Trading Practices Act of 1991 which addresses the so-called "exclusivity clause" of the Commodity Exchange Act (the "CEA"). Although the bill does not affect Freddie Mac's current business in a pervasive manner, certain aspects of the legislation could inhibit future activities, and, as a result, the fulfillment of the corporation's housing mission.

Our first concern is that the bill could potentially harm the continued development of swap markets. Although Freddie Mac's participation in swap transactions historically has been minor, we can foresee an increasing need to utilize this type of transaction. Interest rate and currency swaps are tools that we contemplate employing in order to manage interest rate risk. In addition, Freddie Mac recently has begun to tap global capital markets as a means of broadening the market for mortgage-related securities and lowering mortgage costs for American homebuyers. If, for example, Freddie Mac were to issue mortgage-related securities denominated in a foreign currency, we would want to enter into a currency swap transaction to eliminate foreign exchange rate risks.

The proposed legislation increases uncertainty as to whether these types of transactions are permitted. The bill also appears to inhibit the development of margining and clearing systems that reduce the counterparty credit risks associated with such transactions. Freddie Mac encourages any effort to revise the bill's language to eliminate these potentially adverse developments. We would encourage a broad "exclusion" for swaps from the Commodity Exchange Act as opposed to the somewhat narrow exemptive power given to the CFTC under S.207.

The treatment of so-called "hybrid securities" also concerns us. Although it does not appear that any securities previously issued by Freddie Mac would be affected, the ability to be innovative in creating new securities could be affected, resulting in a disruption in the flow of affordable funds to the American homebuying public. The uncertainty relating to hybrid securities products could delay or prevent the creation of innovative security designs which otherwise would benefit both investors and homebuyers.

I hope this information has been helpful to you. Please do not hesitate to contact us if you require any further assistance.

Very truly yours,

Maud Mater
Senior Vice President
General Counsel and Secretary

3900 Wisconsin Avenue, NW
Washington, DC 20016-2899
202 752 6018

Gary L. Perlin
Senior Vice President–
Finance and Treasurer

FannieMae

April 9, 1991

The Honorable Donald W. Riegle, Jr.
U.S. Senator
324 Senate Hart Office Building
Washington, D.C. 20510

Dear Senator Riegle:

Fannie Mae is a congressionally chartered, shareholder-owned company and the nation's largest investor in home mortgages. We are regular participants in the capital markets and use a broad variety of instruments to achieve our financing and hedging objectives. We have examined S.207, the "Futures Trading Practices Act of 1991" now pending in the Senate. In its current form, this bill raises several questions regarding potential CFTC regulation of swaps and hybrid instruments. These questions would create -- rather than dissolve -- market confusion, hindering economic efficiency and product innovation without necessarily enhancing investor protection or other objects of regulation. Despite the applicable provisions of the "Treasury Amendment" found in Section 2(a)(1)(A) of the Commodity Exchange Act, we comment on this bill because of its broad potential impact on the financial markets generally.

Section 302 of the bill gives the CFTC authority to exempt qualifying transactions from the Act. To qualify for exemption, the transaction must, among other requirements, be entered into "solely between institutional participants." However, while innovative instruments are generally issued and purchased by sophisticated institutional entities, it is problematic to ensure at issuance that all investors will fall under the definition of institutional participant. This requirement may hinder development of innovative financial instruments. Furthermore, difficulty in tracking secondary sales could complicate implementation of this standard. The definition of "institutional participant" also is too narrow. To the extent that any reference to governmental entities is necessary despite the "Treasury Amendment" [Section 2(a)(1)(A) of the Commodity Exchange Act], it should include governmental instrumentalities.

Section 302 separately excludes from regulation under the Act any swap agreement "where each party enters into the swap to hedge or manage a business-related price risk." It

is uncertain why this criterion for exclusion is different from the CFTC's current interpretation of the Act, which excludes swaps that are transacted in conjunction with a line of business. It would be preferable to mirror the criterion used elsewhere in the bill for proposed Section 4(c)(2)(B)(ii) of the Commodity Exchange Act, i.e. "in connection with a line of business or for hedging or risk management purposes." That language would also help avoid the uncertainty that might arise from the less clear and potentially narrower "risk" language proposed for the swap exclusion. Subsection (B) of the proposed swap exclusion also is unclear and could lead to further uncertainty.

Section 302 also exempts swaps, regardless of whether they meet the hedging standard referenced above, if the CFTC deems that the agreements meet each of four conditions. Three of these conditions are quite vague and therefore especially difficult to interpret. First, the exemption must "not be contrary to the public interest," but the public interest in particular transactions may be difficult to define. Second, the requirement that "the creditworthiness of each party to the swap agreement would be a material term of the negotiation of the swap agreement" does not define "material term of the negotiation," leading to further uncertainty. In addition, it would be desirable to have the "creditworthiness" factor met by <u>any</u> party, as opposed to "each" party, as presently proposed. Third, the requirement referring to a trading market gives no guidance as to its meaning or application, which could well be inappropriate. Finally, certainty would be served by making the exemptive provision an exclusion, with appropriate revisions.

Section 303 excludes from regulation under the Act any hybrid instrument which (1) has an option-like component that constitutes less than 50 percent of the value of the instrument, or (2) has a futures-like component which is expected to comprise less than 50 percent of any change in value. However, the bill as written does not specify how value and expectations of changes in value should be determined, nor does it clarify how market participants should calculate whether the 50 percent threshold is exceeded. There is considerable confusion on how these 50 percent tests would be conducted in practice, heightening chances for the unintended restraint of product innovation. While specific guidance could reduce this confusion, any tests mandated in the final version of legislation, or in

accompanying formal interpretations or regulations, should be simple enough to be practicable for market participants, and be consistent with market pricing conventions.

Thank you for considering our views.

Sincerely,

Gary Gerlin

cc: The Honorable Christopher J. Dodd
The Honorable Timothy E. Wirth

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BOND FROM

ROBERT GLAUBER

ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON

July 2, 1991

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, DC 20510-6075

Dear Mr. Chairman:

Enclosed are Under Secretary Glauber's answers to the questions Senator Bond submitted in connection with the April 16 hearing on jurisdictional issues in S. 207.

We appreciate the opportunity to explain our views further and look forward to working with you and other Committee members as the legislation proceeds to conference.

Sincerely,

Mary C. Sophos

Mary C. Sophos
Acting Assistant Secretary
(Legislative Affairs)

Enclosure

Answers to Questions from Senator Bond

Q.1. The Bond-Wirth Alternative would restore intermarket directives contained in S. 207 as introduced that require the SEC and CFTC to adopt rules and regulations to address five critical intermarket issues: (1) coordinated circuit breakers, (2) cross-margining, (3) coordinated clearance and settlement systems, (4) detection and deterrence of frontrunning and other intermarket trading abuses, and (5) uniform policies with regard to negotiation and development of international regulatory agreements and standards involving intermarket issues.

(a). The Market Reform Act of 1990 (PL 101-432) required the SEC and CFTC to report on progress made to address intermarket issues. In contrast, the Bond-Wirth Alternative requires the adoption of rules and regulations to address intermarket issues. Nonetheless, some claim that the Bond-Wirth Amendment duplicates the provisions of the Market Reform Act. Are the intermarket provisions of the Market Reform Act identical to the intermarket directives in the Bond-Wirth Alternative? If not, provide a side-by-side comparison of these provisions and describe the differences?

A.1(a). The intermarket provisions of the Market Reform Act differ from the intermarket directives in the Bond-Wirth Alternative with respect to actions required and the scope of coverage. As you point out, the Market Reform Act requires the SEC and CFTC to report on progress made to address intermarket issues. In contrast, the Bond-Wirth Alternative requires agency action in the form of rules, regulations, policy statements, etc. addressing intermarket issues.

The basic difference in scope is that the Bond-Wirth Alternative focuses on specific issues while the Market Reform Act covers broad headings encompassing the Bond-Wirth issues, among others:

Market Reform Act	Bond-Wirth Alternative
o Coordination of regulatory activities to ensure integrity and competitiveness of U.S. financial markets	o Coordinated <u>circuit breakers</u>
o Coordinated mechanisms across marketplaces to protect the payments and market systems during market emergencies	o Effective prohibitions on intermarket <u>frontrunning</u>
	o Linked or coordinated facilities for the <u>clearance and settlement</u> of transactions

- Adequacy of margin levels and use of leverage by market participants
- Other issues and concerns relating to the soundness, stability and integrity of domestic and international capital markets
- Cross-margining of intermarket positions and the use of such intermarket positions as security interest for loans and other extensions of credit and the establishment or maintenance of margin on futures and options contracts
- Policies with regard to the negotiation and development of international regulatory agreements and standards involving intermarket issues
- Other intermarket issues as the issues arise

Q.1(b). Have the SEC and CFTC adopted all of the rules and regulations necessary to achieve the objectives of the intermarket directives contained in the Bond-Wirth Alternative?

A.1(b). Although progress has been made on each of these issues, the objectives have not been fully achieved. We believe several of these objectives need to be pursued more expeditiously than they have been in the past (particularly clearance and settlement and cross-margining), but not so aggressively as to risk unintended consequences.

Q.1(c). For each of the five intermarket issues contained in the Bond-Wirth Alternative, describe the actions already taken by the SEC and CFTC to implement those objectives?

A.1(c). In general, significant progress has been made on circuit breakers. Some progress has been made on frontrunning, clearance and settlement, cross-margining, and international regulation. These issues are discussed in the May 1991 reports to Congress required under section 8(a) of the Market Reform Act.

Q.1(d). For each of the five intermarket issues contained in the Bond-Wirth Alternative, what rules and regulations have yet to be adopted to fully implement those objectives?

A.1(d). Circuit breakers should be more closely coordinated. The securities and futures exchanges should establish more effective prohibitions on intermarket frontrunning, including a common definition, and improved market

surveillance and information sharing for enforcement purposes. Further improvements in intermarket clearance and settlement are needed, for example in the areas of cross-margining, monitoring of net financial exposure of clearing members, uniform requirements for the transfer and pledge of securities, and international clearance and settlement standards like those proposed by the Group of Thirty.

Q.1(e). Do you support these provisions? If not, why not?

A.1(e). As discussed more fully in the Report of the Presidential Task Force on Market Mechanisms and in testimony by Secretary Brady and me, Treasury supports the policy underlying this provision. However, we believe it is unnecessary for Congress to direct the SEC and CFTC to take action in these areas, inasmuch as: (1) the Market Reform Act already requires action to facilitate linked or coordinated clearance and settlement facilities, (2) the reporting requirement under the Market Reform Act will motivate the agencies to focus on other issues identified in the Bond-Wirth Alternative, and (3) the Working Group on Financial Markets has made some progress on these issues, and we expect further improvements in the future.

Q.2. The Bond-Wirth Alternative would exclude from the federal commodity laws bank deposits and loans made by federally insured depository institutions.

(a). Do you support these provisions? If not, why not?

A.2(a). In general, we believe that bank deposits and loans made by federally insured depository institutions should be excluded from application of the Commodity Exchange Act. The Senate bill, S. 207, accomplishes this goal regarding deposits by directing the CFTC to exempt most deposit instruments. Similar treatment should be afforded to bank loans. To the extent the Bond-Wirth Alternative accomplishes the same goal, we do not object to it.

Q.2(b). Under current federal and state banking laws can banks convert loans and bank deposits into futures contracts? If so, how?

A.2.(b). We are uncertain about the type of situation the question is addressing, however, as you know, banks can offer loans and deposits that have interest rates based on an index or on the value of a commodity such as gold. Such loans and deposits are subject to the banking laws and regulated by the banking agencies as such. Some have argued that such deposits have an element of "futurity" and therefore may themselves constitute futures contracts subject to the Commodity Exchange Act.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BOND FROM
RICHARD BREEDEN

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

June 26, 1991

CHAIRMAN'S OFFICE
MAILED
JUN 26 1991
Signed by:

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Riegle:

Our responses to Senator Bond's further questions regarding S.207, sent under cover of your letter of April 24, 1991, are enclosed. I apologize for the delay in getting these responses to you.

If there are any further questions regarding these issues, please do not hesitate to contact me.

Sincerely yours,

Richard C. Breeden
Chairman

Enclosure

QUESTIONS FOR CHAIRMAN RICHARD BREEDEN
FROM SENATOR BOND
APRIL 16, 1991

Q1. The Bond-Wirth Alternative would restore intermarket directives contained in S.207 as introduced that require the SEC and CFTC to adopt rules and regulations to address five critical intermarket issues: (1) coordinated circuit breakers, (2) cross-margining, (3) coordinated clearance and settlement systems, (4) detection and deterrence of frontrunning and other intermarket trading abuses, and (5) uniform policies with regard to negotiation and development of international regulatory agreements and standards involving intermarket issues.

(a) The Market Reform Act of 1990 (PL 101-432) required the SEC and CFTC to report on progress made to address intermarket issues. In contrast, the Bond-Wirth Alternative requires the adoption of rules and regulations to address intermarket issues. Nonetheless, some claim that the Bond-Wirth Amendment duplicates the provisions of the Market Reform Act. Are the intermarket provisions of the Market Reform Act identical to the intermarket directives in the Bond-Wirth Alternative? If not, provide a side-by-side comparison of these provisions and describe the differences.

Answer: The intermarket provisions of the Market Reform Act of 1990 ("Market Reform Act") are not identical to the intermarket directives in the Bond-Wirth Alternative. The specific language of each is set forth side-by-side in Attachment A.

As you have noted, the Market Reform Act and the Bond-Wirth Alternative address intermarket issues in different ways. Under the Market Reform Act, the Securities and Exchange Commission ("SEC"), the Commodity Futures Trading Commission ("CFTC"), the Board of Governors of Federal Reserve System ("Federal Reserve Board"), and the United States Department of the Treasury ("Treasury") must file annual reports with Congress concerning steps that the agencies have taken to address intermarket issues; the agencies are not required to take any regulatory action regarding such issues.[1] The Bond-Wirth Alternative, in contrast, explicitly instructs the SEC and the CFTC to adopt rules and regulations regarding certain specifically identified intermarket issues.[2]

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[1]The first report under the Market Reform Act was filed on May 31, 1991. See Securities and Exchange Commission, Report on Intermarket Coordination Pursuant to Section 8(a) of the Market Reform Act of 1990 (May 31, 1991).

[2]Of course, the SEC and the CFTC must be authorized to promulgate such rules and regulations under their governing statutes.

For example, the Bond-Wirth Alternative directs the SEC and the CFTC to adopt rules on circuit breakers, to implement prohibitions on intermarket frontrunning, to mandate that self-regulatory organizations and contract markets establish effective procedures for the sharing of market surveillance information for the detection of intermarket frontrunning, fraud, and other violations, and to establish policies on the negotiation and development of international regulatory agreements and standards. The Market Reform Act does not refer to any of these specific issues, and contains no comparable mandates. Instead, it instructs the agencies to detail the efforts they have made to ensure the integrity and competitiveness of U.S. financial markets.

The Bond-Wirth Alternative also directs the SEC and the CFTC to take action concerning particular issues in the area of clearance and settlement. For example, the Bond-Wirth Alternative requires the SEC and the CFTC to adopt rules that would foster the establishment of coordinated facilities for the clearance and settlement of transactions. The Bond-Wirth Alternative also instructs the two agencies to take the steps necessary to authorize the prompt implementation of systems for the cross-margining of intermarket positions and for the use of such intermarket positions as security interests for loans and other extensions of credit. The Market Reform Act, in contrast, requires the agencies to report on efforts they have made to formulate coordinated mechanisms to protect the payments and market systems during market emergencies, and on the progress, if any, they have made in establishing coordinated facilities for the clearance and settlement of transactions in securities, securities options, futures contracts, options on futures contracts, and commodity options.

S.207 also contains new authority for the Federal Reserve Board to regulate margin levels on stock index futures. The Bond-Wirth Alternative would retain this provision of S.207. The Market Reform Act, however, only requires the SEC, the CFTC, the Federal Reserve Board, and the Treasury to report to Congress as to each respective agency's views on the adequacy of margin levels and the use of leverage by market participants.

Finally, the Market Reform Act requires the SEC and the CFTC to report to Congress on other issues relating to the soundness, stability, and integrity of domestic and international capital markets as may be appropriate. The Bond-Wirth Alternative takes a more pro-active approach by instructing the two agencies to identify and address other intermarket issues as they arise.

Q.1.(b) Have the SEC and CFTC adopted all of the rules and regulations necessary to achieve the objectives of the intermarket directives contained in the Bond-Wirth Alternative?

(c) For each of the five intermarket issues contained in the Bond-Wirth Alternative, describe the actions already taken by the SEC to implement those objectives.

(d) For each of the five intermarket issues contained in the Bond-Wirth Alternative, what rules and regulations have yet to be adopted to fully implement those objectives?

Answer: The SEC and the CFTC have adopted many of the rules and regulations necessary to achieve the objectives of the intermarket directives contained in the Bond-Wirth Alternative. Some regulatory actions must still be taken, however, before the objectives of the intermarket directives can be fully achieved. The progress toward achieving the objectives of the intermarket directives, and the regulatory steps that still must be taken, are described below.

1. Coordinated Circuit Breakers

The SEC and the CFTC have, with the cooperation of the securities and futures self-regulatory organizations ("SROs"), adopted the rules and regulations necessary to implement basic circuit breaker mechanisms on all equity and derivative markets. Under the circuit breaker mechanisms, one and two hour trading halts are initiated in all securities when the Dow Jones Industrial Average ("DJIA") declines 250 and 400 points, respectively.[3] These circuit breaker mechanisms, which were approved by the SEC on a pilot basis, are still in place today, and the pilot has been extended until the end of October 1991.[4]

In addition, both the SEC and the CFTC have approved SRO rules implementing several so-called "speed bumps" that are designed to dampen market volatility during periods of market turbulence. For example, the SEC has approved a New York Stock Exchange ("NYSE") rule that requires program trading-related market orders in each component stock of the Standard & Poor's 500 Stock Price Index ("S&P 500") to be routed into separate electronic "side car" files for a five-minute period when the primary S&P 500 futures contract traded on the Chicago Mercantile

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[3]Securities Exchange Act Release No. 26198 (Oct. 19, 1988), 54 FR 41637.

[4]Securities Exchange Act Release No. 28580 (Oct. 25, 1990), 55 FR 45815.

Exchange ("CME") declines 12 points from its previous day's closing value.[5]

Second, the SEC approved an NYSE rule (Rule 80A) establishing a pilot program that places conditions on index arbitrage orders to buy or sell component stocks of the S&P 500 Index when the DJIA advances or declines by 50 points or more from its closing value on the previous day.[6] The Rule 80A pilot program, which ends on July 31, 1991, is designed to ensure that index arbitrage will only be exercised in a market-stabilizing manner during volatile market conditions.[7]

Finally, the SEC has approved several proposals by the options exchanges that provide for additional trading halt provisions for stock index options which are triggered by, among other things, the activation of price limits in the stock index

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[5]In the "side car" files, buy and sell orders are matched and, at the end of the five-minute period, order imbalances (if any) are reported to the specialists for each stock. At that point, the orders within the "side car" files are eligible for execution. In addition, if there are large order imbalances, halts for particular stocks will be declared. Only market orders routed through the NYSE's automated order routing system, SuperDOT, are placed in the "side car" files. Securities Exchange Act Release No. 26198 (Oct. 19, 1987), 53 FR 41637.

[6]When the DJIA advances 50 points, Rule 80A provides that index arbitrage orders to buy component stocks of the S&P 500 Index must be entered with a "buy minus" instruction, which means that such orders only can be executed when the last reported price movement in each of those stocks (including the price movement, if any, from the arbitrage transaction) was a decline in the price of that stock. Conversely, when the DJIA declines 50 points, Rule 80A provides that index arbitrage orders to sell must be entered with a "sell plus" instruction, which means that such orders only can be executed when the last reported price movement in each of those stocks (including the price movement, if any, from the arbitrage transaction) was an increase in the price of that stock. Once activated, Rule 80A's conditions remain in effect for the remainder of the trading day, unless the DJIA moves to within 25 points of its previous day's close. They are reinstated if the DJIA once again moves 50 points from the previous day's close. Securities Exchange Act Release No. 28282 (July 30, 1990), 55 FR 31468.

[7]The SEC also has approved an NYSE proposal that exempts index arbitrage market-on-close orders from Rule 80A's conditions on Expiration Fridays in order to facilitate the liquidation of stock positions previously established in connection with derivative index products. Securities Exchange Act Release No. 28553 (Oct. 18, 1990), 55 FR 42926.

futures markets. Under these provisions, the options exchanges have discretionary authority to delay the commencement of trading or to halt trading in certain stock index options if certain stock index futures are subject to a price limit.[6]

The SEC and CFTC consistently have solicited each other's views before approving such "speed bumps." These procedures are not identical in each market, but rather reflect the different trading characteristics of each market. This is due in large part to the fact that the stock index futures markets have a series of price limits, most of which have no counterpart in the stock or options markets, that in practice may result in short trading halts in the stock index futures markets. When those price limits are in effect, some trades that would otherwise be executed in the stock index futures market may be diverted to the stock index options market, putting additional selling pressure on stock index option prices. This was particularly evident on October 13, 1989, when price limits were activated in the stock index futures markets and the stock index options markets did not immediately halt trading.[9]

In this connection, although the Commission staff has encouraged the options markets to consider developing additional procedures to address price limits in the futures markets, the options markets have, thus far, not concluded that such procedures are feasible. Instead, those markets retain discretionary authority to respond to particular circumstances as they arise.

2. Cross-Margining

The SEC and the CFTC have taken many of the regulatory actions necessary to implement a system of cross-margining securities and futures positions. A few remaining steps, however, still must be taken, and the intermarket directives contained in the Bond-Wirth Amendment could expedite that process.

Two cross-margining arrangements already have been implemented. First, in 1988, the SEC and the CFTC approved a cross-margining arrangement between the Options Clearing Corporation ("OCC") and the Intermarket Clearing Corporation

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[6]See, e.g., Securities Exchange Act Release No. 25600 (Apr. 19, 1988), 53 FR 13458; Securities Exchange Act Release No. 26198 (Oct. 18, 1988), 53 FR 41637.

[9]At 3:07 p.m. on October 13, the primary S&P 500 future contract traded on the CME hit its intermediate 12-point price limit. Trading in the three major stock index options, however, was not halted until about 3:16.

("ICC").[10] Under that arrangement, ICC maintains the following positions for participants in the OCC/ICC cross-margining program, to the extent that such positions are proprietary: (1) options on foreign currencies traded on the Philadelphia Stock Exchange; (2) stock index options traded on national securities exchanges; and (3) foreign currency and stock index futures traded on the Philadelphia Board of Trade, the New York Futures Exchange, and the American Commodities Corporation. ICC calculates and collects a single clearing system margin requirement for all positions held by ICC under the program. By maintaining physical control of both sides of futures/options hedge and arbitrage positions, ICC has the ability to liquidate a position in event of a participant insolvency and can calculate a single net margin amount based upon the hedged position. Accordingly, ICC can reduce initial margin requirements for intermarket positions of joint members of OCC and ICC.

Use of the OCC/ICC cross-margining system, however, has been negligible. OCC reports that fewer than ten of OCC's 190 clearing members are eligible to participate in the ICC cross-margin arrangement, and only one member currently uses the ICC cross-margin arrangement.

In an effort to expand the use of this program, OCC and ICC have filed proposals to expand the program to affiliated clearing members.[11] ICC also filed a petition with the CFTC in 1988 for rulemaking which would, in effect, make cross-margining arrangements available to accounts other than proprietary accounts.[12]

Second, on September 23, 1988, the Chicago Mercantile Exchange ("CME") and OCC announced an agreement to pursue jointly arrangements to provide cross-margining of options and futures on stock index products that are issued and cleared by both organizations. The OCC/CME arrangement differs somewhat from the ICC/OCC cross-margin arrangement in that OCC and CME in effect share control over clearing member options and futures positions. Under the OCC/CME arrangement, OCC maintains control of OCC-cleared options (which will be held in a special "x-m" account, "x-m" meaning cross margin) and CME maintains control of CME-cleared futures and options on futures (which also will be held in a special "x-m" account). Clearing members electing to participate in the cross-margin arrangement must agree to grant OCC and CME liens on futures positions maintained at CME and

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[10]See Securities Exchange Act Release No. 26153 (October 3, 1988), 53 FR 39567.

[11]See Securities Exchange Act Release No. 27749 (February 28,1990), 55 FR 8276.

[12]See 51 FR 41117.

options positions maintained at OCC, respectively. Funds paid to the clearing member or generated by liquidating positions maintained in "x-m" accounts, in essence, are shared between OCC and CME, as are any losses resulting from position liquidations. OCC and CME exchange position data concerning participants in this service, calculate independently margin obligations on futures and options portfolios, and coordinate collection of margin deposits on those positions.

The benefits of the OCC/CME pilot were evidenced during the market turbulence on October 13 and 16, 1989. On these two days, the two firms participating in this pilot paid $150 million less margin in their cross-margin accounts than they would have paid if this facility had not been available.

In addition, OCC and CME have filed proposals with the SEC and CFTC, respectively, that would expand the use of the OCC/CME cross-margin program to include the accounts of market-makers, floor traders, and specialists.[13] The SEC and the CFTC are working closely to address the regulatory issues raised by this proposal, and it is expected that the two agencies will issue the necessary approval orders in the near future.

Finally, the OCC has filed a proposal with the SEC that would establish a cross-margining program between OCC and the Board of Trade Clearing Corporation ("BOTCC"), which acts as the clearing facility for the Chicago Board of Trade ("CBT").[14] The OCC/BOTCC arrangement is modeled after the OCC/CME arrangement, and would include the accounts of market-makers, floor traders, and specialists. This proposal is currently under review.

3. Coordinated Clearance and Settlement Systems

The SEC and the CFTC have made considerable progress in coordinating clearance and settlement systems in the securities and futures markets. Nevertheless, the SEC believes that the Bond-Wirth Alternative's intermarket directives could provide the impetus to achieve greater coordination and efficiency in this area.

One aspect of coordinated clearance and settlement has been improved intermarket coordination and communication among clearing organizations for securities and derivative products. First,

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[13]See Securities Exchange Act Release No. 27717 (March 1, 1990), 55 FR 7389; Letter from Lori R. Burns, Assistant General Counsel, CME, to Jean A. Webb, Secretary, CFTC (Jan. 30, 1990).

[14]See Securities Exchange Act Release No. 29142 (May 6, 1991), 65 FR 20634.

the Securities Clearing Group ("SCG"), which consists of ten securities clearing agencies, is currently working on establishing an information database to be shared among participants in the SCG on a real-time basis. Once this initiative is completed, the SCG expects that it will either make information available to the BOTCC for incorporation into its pay/collect database or invite commodity clearing organizations such as BOTCC to share data through the SCG system. Second, OCC currently participates in the BOTCC's pay/collect system, although OCC has indicated that it would prefer to have an independent agency gather and distribute the information. Third, the SCG has made available to the BOTCC the SCG list of common members, in order to develop and keep current a master list of members at securities and commodities clearing organizations.

In addition to the above initiatives, securities and commodities clearing organizations, banks, and federal regulators have met several times under the auspices of CME/CBT clearing organization/clearing bank roundtables. During the past year, four roundtable meetings have taken place, at which participants have explored a variety of issues, including Fedwire operating hours, processing payments in foreign currency, and information sharing arrangements with clearing banks.

Finally, CME and OCC have expanded their information sharing arrangements in support of the cross-margin arrangements. OCC and CME have agreed to share information concerning the status of members using the "x-m" accounts, including whether such members have been placed on surveillance status.

In January 1989, at the SEC's request, the American Bar Association Section on Business Law formed an advisory committee to examine the need for harmonization of bankruptcy laws as well as any state commercial law impediments to efficient clearance and settlement of securities and futures transactions. The advisory committee, which is chaired by Robert Haydock[15] and is generally known as the "Haydock Committee," includes representatives of the SEC, the CFTC, the OCC, the Depository Trust Company, the National Securities Clearing Corporation, the CME, the CBT, the Federal Reserve Bank of New York, the U.S. Treasury, and other state commercial and bankruptcy law experts and practitioners. The Haydock Committee published a draft report for comment on February 15, 1991 that identifies, among other things, those areas of state commercial law that may impede the pledge of intermarket positions.

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[15]Mr. Haydock is of counsel for the Boston, Massachusetts law firm of Bingham, Dana & Gould. Mr. Haydock previously served as the Commissioner, Massachusetts Commission on Uniform State Laws and has been a member of the Permanent Editorial Board for the Uniform Commercial Code since 1974.

In addition, the Market Reform Act gave the SEC authority to adopt rules or regulations that would pre-empt state law in order to establish uniform conventions with respect to the transfer and pledge of securities.[16] The SEC is studying whether any rule-making is necessary at the present time.

Notwithstanding the progress that has been made, certain issues remain to be addressed. The first such issue is the lack of coordinated bank and financial market holidays. At certain times during the year, there are holidays on which the financial markets are open but banks are closed. Because the integrity of the clearance and settlement system depends on the availability of the payment, credit, and liquidity services provided by the banking system, this lack of coordination raises several serious concerns.

The potential for the lack of coordination between the days that markets are open and banks are closed to cause serious financial problems for clearing agencies is most acute during periods of extreme market volatility. For example, as settlement guarantors, the greatest risk to clearing agencies is that their members will fail to meet their payment or delivery obligations. To protect themselves against this risk, clearing agencies typically require their members to post liquid collateral. Because the likelihood of member default increases as the markets become more volatile, clearing agencies typically have the authority to require members to post additional collateral upon demand.

Because of the interdependence between the banking and the clearance and settlement system, an adverse market movement on a

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[16]In addition, the Market Reform Act required the SEC to establish an Advisory Committee and to consider the views of that Advisory Committee prior to exercising its rulemaking authority. Under its charter, the Advisory Committee will consider and report to the SEC on the areas in which state commercial laws and related state or federal laws (including those laws relating to choice and conflict of law) concerning the transfer and pledge of certificated and uncertificated securities, limited interests (including security interests) in such securities, or the creation or perfection of security interests in such securities, do not provide the necessary certainty, uniformity, and clarity for purchasers, setters, owners, lenders, borrowers and financial intermediaries concerning their respective rights and obligations. The Advisory Committee will also consider any manner in which such laws as currently exist adversely impact the national system for the clearance and settlement of securities transactions. The Committee will recommend any desirable means of enhancing the prompt, accurate and safe clearance and settlement of securities transactions.

day when the banks are closed could cause serious difficulties for clearing agencies and their members. Although the SEC and CFTC have made continuing efforts to alleviate these concerns, any final resolution of these issues depends, in part, on the availability of the payment system (i.e., Fedwire).

In addition, the SEC believes that there are other initiatives requiring intermarket coordination that would strengthen the nation's clearance and settlement systems. For example, the SEC notes that many market participants make and receive daily payments at various stock, options and equity derivative clearing organizations. However, because of a lack of coordination among these organizations, these market participants are unable to net a payment obligation at one clearing organization against a receipt of payment from another clearing organization. The absence of such netting facilities reduces the efficiency of the domestic payments system and imposes unnecessary liquidity demands on market participants.

4. Detection and Deterrence of Frontrunning and Other Intermarket Trading Abuses

With respect to intermarket frontrunning prohibitions, the SEC and CFTC have been working on the development of effective sharing of data and information and the coordination of investigative and prosecutorial functions. Significant progress toward the accomplishment of these goals already has been achieved, although further steps can and should be taken with respect to routine information-sharing.

For example, the New York Stock Exchange ("NYSE"), the CME, and the New York Futures Exchange ("NYFE") have agreed upon a common definition of intermarket index futures frontrunning and upon formal procedures for sharing surveillance and investigative information to curb commonly defined abuses. These proposals have been approved by the SEC and the CFTC as amendments to NYSE, CME, and NYFE rules, and exchange members are now on notice that intermarket index futures frontrunning is prohibited. The NYSE, CME and NYFE also have concluded surveillance information sharing agreements and presently transmit surveillance information between exchanges on a routine basis.[17]

On September 12, 1989, the CBT unilaterally issued a circular to its members based on the common definition of inter-

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[17]Since May 2, 1988, the NYSE has required member firms to report routinely all program trading for proprietary and customer accounts. The collection, analysis and sharing with futures market regulatory authorities of this information is essential for effective surveillance for intermarket index futures frontrunning.

market index futures frontrunning between the CME and the NYSE. The CBT and the NYSE also signed a surveillance information sharing agreement similar to the CME/NYSE agreement on May 16, 1990.

The CME and the Chicago Board Options Exchange ("CBOE") are in the process of negotiating a common definition of intermarket frontrunning that would prohibit trading of stock index options to take advantage of material nonpublic information concerning the execution of an order for stock index futures contracts. Once the CBOE and the CME reach an agreement on the contours of intermarket index futures frontrunning prohibition, the exchanges will enter into a routine surveillance information sharing agreement.

It should be stressed, however, that these exchange-to-exchange information sharing agreements are subject to troubling limitations in scope and flexibility, and are inferior to the comprehensive information sharing that takes place on a routine basis among the stock and options markets through the Intermarket Surveillance Group. Therefore, although the current intermarket frontrunning agreements constitute a useful beginning point, the SEC believes that the SEC, the CFTC, and the SROs should work to develop broader agreements to share intermarket trading information on a more routine basis. The intermarket directives contained in the Bond-Wirth Alternative could provide valuable Congressional guidance in this regard.

5. Uniform Policies with Regard to Negotiation and Development of International Regulatory Agreements and Standards Involving Intermarket Issues

As foreign securities markets have grown and as cross-border securities trading has flourished, the SEC has increased its efforts to coordinate its activities with those of foreign regulators. Although the SEC has coordinated its efforts when possible with the CFTC, the intermarket directives in the Bond-Wirth Alternative would provide valuable Congressional guidance to both agencies in structuring their international activities.

In order to enforce the United States securities laws effectively, the SEC in recent years has experienced a growing need for information that is located abroad. As a result, the SEC has actively sought to develop information-sharing agreements on a bilateral basis with securities regulators of countries with active securities markets. For example, the SEC pioneered the use of Memoranda of Understanding ("MOUs") as a mechanism by which regulators could assist one another in investigations. The SEC has an aggressive program of trying to establish MOUs or similar agreements with countries from which the SEC regularly needs assistance. The information-sharing arrangements created

pursuant to these MOUs provide an effective and efficient means of seeking evidence abroad while avoiding the conflicts that may result from differences in regulatory systems.

In particular, the SEC has entered into various arrangements with foreign authorities in Switzerland, Japan, the United Kingdom, Brazil, Italy, the Netherlands, France, Luxembourg, Mexico, Hungary, and three provincial authorities in Canada. In addition, the staff coordinates closely with regulators with whom it has information-sharing arrangements in order to develop ways to implement and improve these arrangements. The SEC also cooperates on an informal basis with foreign regulators with whom it does not have explicit information-sharing arrangements.

The SEC's ability to enter into comprehensive information-sharing agreements with foreign regulators was enhanced by the International Securities Enforcement Cooperation Acts of 1988 and 1990. As a result of this legislation, the SEC now has the ability to compel, through the assistance of foreign regulatory authorities, the production of evidence and testimony that is otherwise outside the territory and jurisdiction of the United States. As other countries implement similar legislative provisions, the SEC will be able to expand further the network of comprehensive information-sharing agreements.

In addition to these country-by-country efforts to improve international regulatory cooperation, the SEC has supported efforts to develop a multilateral framework for information-sharing among regulators, securities markets, and self-regulatory organizations. Toward this end, the SEC has taken a strong leadership role in the International Organization of Securities Commissions ("IOSCO"). Thus, in 1990, Chairman Breeden served as Chairman of the IOSCO Executive Committee.

In addition, Chairman Breeden directed the preparation of a strategic assessment of the IOSCO Technical Committee's operation and structure. This strategic assessment, which was adopted by IOSCO, reorganizes the subcommittees operating under the Technical Committee in order to make the work of the subcommittees more efficient and more effective. In this regard, the Technical Committee has established as a priority an examination of the regulation of secondary markets, including the interrelationship of markets for derivative products and the related cash markets. The focus of this project includes the development of procedures and mechanisms for sharing information between and among the various participants in order to ensure the continued integrity and soundness of these markets. In November 1990, Chairman Breeden was elected to serve as the chairman of Technical Committee of IOSCO for a two year term.

Additionally, the SEC is actively involved in providing technical assistance to other countries concerning the develop-

ment and regulation of their securities markets. On May 25, 1990, Chairman Breeden announced the establishment of the SEC's Emerging Markets Advisory Committee ("EMAC") to advise the SEC on how best to utilize its resources for assisting foreign regulators and to provide technical and other assistance to the SEC regarding requests from governmental authorities for assistance in developing securities and other financial markets. The EMAC is intended to ensure that the United States is in a position to provide strong and effective leadership to emerging markets and to help the SEC build effective relationships with merging market countries. Among the countries to which the SEC and the EMAC have provided technical assistance are Hungary, Poland, Mexico, and Greece.

In addition, in the spring of 1991, the SEC, assisted by members of the EMAC and other government agencies, held the first International Institute for Securities Market Development in Washington, D.C. The goal of the Institute was to provide regulators from countries with developing securities markets with an organized and comprehensive overview of the critical building blocks necessary for growth and development of strong and vibrant securities markets. Senior officials from over thirty countries attended the Institute.

Q.1.(e) Do you support this provision of the Bond-Wirth Alternative? If not, why?

Answer: The SEC supported the Bond-Wirth Alternative as a responsible and practical approach to financial regulation. The explicit indications of Congressional intent provided in the Bond-Wirth intermarket directives would have provided the SEC and the CFTC with important guidance and direction in formulating regulatory approaches to specific intermarket problems.

Comparison of Provisions of Market Reform Act of 1990 and Bond-Wirth Alternative on Intermarket Issues

ISSUES	MARKET REFORM ACT	BOND-WIRTH ALTERNATIVE
1. Coordinated Circuit Breakers	Not specifically addressed. The Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the SEC, and the Chairman of the CFTC shall report to the Congress on the efforts their respective agencies have made relating to the coordination of regulatory activities to ensure that the integrity and competitiveness of U.S. financial markets.	The SEC and CFTC shall adopt such rules and regulations, issue such orders, and, subject to applicable requirements, approve such rules of the self-regulatory organizations and contract markets subject to their respective regulatory authority as may be necessary to strengthen the overall stability of domestic equity and equity derivative markets and maintain fair and orderly markets through the adoption and approval of appropriate coordinated "circuit breaker" mechanisms and similar requirements.
2. Detection and Deterrence of Frontrunning and Other Intermarket Trading Abuses	Not specifically addressed. See (1) above.	The SEC and CFTC shall establish (for all domestic equity and equity derivative markets) effective prohibitions on intermarket frontrunning, and require the self-regulatory organizations and contract markets subject to their respective regulatory authority as may be necessary to establish effective procedures for sharing price, trading and enforcement data for the detection of intermarket frontrunning, fraud, and other violations.
3. Uniform Policies Regarding Negotiation and Development of International Regulatory Agreements and Standards Involving Intermarket Issues	Not specifically addressed. See (1) above.	The SEC and CFTC shall establish policies with regard to the negotiation and development of international regulatory agreements and standards involving intermarket issues.

ISSUES	MARKET REFORM ACT	BOND-WIRTH ALTERNATIVE
4. Margin Levels	[T] he Chairman of the SEC and the Chairman of the CFTC shall report to the Congress on the views of their respective agencies with respect to the adequacy of margin levels and use of leverage by market participants.	S.207 contains new authority for the Federal Reserve Board to regulate margin levels on stock index futures. The Bond-Wirth Alternative would retain this provision of S.207.
5. Cross-margining	Not specifically addressed. See (4) above.	The SEC and CFTC shall adopt such rules and regulations, issue such orders, and, subject to applicable requirements, approve such rules of the self-regulatory organizations and contract markets and clearing organizations subject to their respective regulatory authority as may be necessary or appropriate to authorize the prompt implementation of systems for the cross-margining of intermarket positions and the use of such intermarket positions as security interest for loans and other extensions of credit.
6. Coordinated Clearance and Settlement Systems	(a) [T] he Chairman of the SEC and the Chairman of the CFTC shall report to the Congress on the efforts their respective agencies have made to formulate coordinated mechanisms across marketplaces to protect the payments and market systems during market emergencies. (b) The SEC, in consultation with the CFTC, the Board of Governors of the Federal Reserve System, and other relevant regulatory authorities, shall examine progress toward establishing linked or coordinated facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options, and shall submit to the Committees on Energy and Commerce and Agriculture of the House of Representatives and the Committees on Banking, Housing, and Urban Affairs and Agriculture, Nutrition, and Forestry of the Senate no later than 2 years from the date of enactment of this section, a report	The SEC and CFTC shall adopt (for all domestic equity and equity derivative markets) such rules and regulations, issue such orders, and approve, subject to applicable requirements, such rules of the self-regulatory organizations and contract markets subject to their respective regulatory authority as may be necessary to facilitate the establishment of linked or coordinated facilities for the clearance and settlement of transactions

ISSUES	MARKET REFORM ACT	BOND-WIRTH ALTERNATIVE
7. Other Issues	[T]he Chairman of the SEC, and the Chairman of the CFTC shall report to the Congress on such other issues and concerns relating to the soundness, stability, and integrity of domestic and international capital markets as may be appropriate.	The SEC and CFTC, in consultation with the Secretary of Treasury and Chairman of the Board of Governors of the Federal Reserve System, shall identify and address other intermarket issues as the issues arise.
8. Reporting Requirements	The reporting requirements are set forth in (1) through (7) above.	The SEC and CFTC shall report to Congress on the actions they have taken to carry out the above listed requirements, not later than 15 months after the effective date of this Act.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BOND FROM

WENDY GRAMM

Q1. The Bond-Wirth Alternative would restore intermarket directives contained in S.207 as introduced that require the SEC and CFTC to adopt rules and regulations to address five critical intermarket issues: (1) coordinated circuit breakers, (2) cross-margining, (3) coordinated clearance and settlement systems, (4) detection and deterrence of frontrunning and other intermarket trading abuses, and (5) uniform policies with regard to negotiation and development of international regulatory agreements and standards involving intermarket issues.

(a) The Market Reform Act of 1990 (PL 101-432) required the SEC and CFTC to report on progress made to address intermarket issues. In contrast, the Bond-Wirth Alternative requires the adoption of rules and regulations to address intermarket issues. Nonetheless, some claim that the Bond-Wirth Amendment duplicates the provisions of the Market Reform Act. Are the intermarket provisions of the Market Reform Act identical to the intermarket directives in the Bond-Wirth Alternative? If not, provide a side-by-side comparison of these provisions and describe the differences?

A1(a). The intermarket provisions of The Market Reform Act of 1990 (MRA) are not precisely identical to the intermarket directives in the Bond-Wirth Alternative (BW). However, the objectives of MRA and BW and the results they would achieve are very similar. The MRA requires an annual report to Congress on all the intermarket issues addressed by BW. MRA also requires, for example, the Treasury Department, the Federal Reserve Board, the SEC and the CFTC to give their views annually with respect to the adequacy of margin levels and use of leverage by market participants.

Q1(b). Have the SEC and CFTC adopted all of the rules and regulations necessary to achieve the objectives of the intermarket directives contained in the Bond-Wirth Alternative?

A1(b). The CFTC has adopted rules and policies or approved rules of the futures industry self-regulatory organizations concerning each of the intermarket directives in BW. Concerning coordinated circuit breakers, the futures exchanges where stock index futures are traded and the major securities exchanges have adopted circuit breakers similar to those recommended by the President's Working Group on Financial Markets, i.e., downward price limits on stock index futures and options, and trading halts at price levels comparable to 250- and 400-point declines in the Dow Jones Industrial Average (DJIA) from the previous day's closing value (one hour and two hours halts, respectively). In addition, several futures exchanges have adopted "shock absorbers" or "speed bumps" which are intended to restrict or slow down, but not to halt, stock index futures trading. These less restrictive trading rules consist of price limits at levels much narrower than the 250- and 400-point DJIA-equivalent trading halt triggers.

With respect to cross-margining, at the present time, both the CME and the Intermarket Clearing Corporation (ICC) operate separate cross-margining systems with the Options Clearing Corporation (OCC) for margining of participant clearing members' proprietary intermarket positions. Recently, the CME and ICC proposed to expand their respective cross-margining systems with the OCC to include the non-proprietary accounts of participating clearing members containing the positions of securities and futures market professionals. The Commission is continuing to coordinate review of these proposals with the SEC, which also has had the matter under review, and expects to act on them shortly.

In the area of coordinated clearing and settlement systems, a number of futures market and intermarket coordinating groups have been established, including, for example, the Intermarket Financial Surveillance Group which includes representatives of futures and securities self-regulatory organizations, and the Clearing Organization and Clearing Bank Roundtable, which meets on a quarterly basis in order to maintain lines of communication among clearing organizations in the futures and securities industries, the banks which support settlement services for these clearing organizations and their regulators. The roundtable group has addressed a wide range of topics, including the expansion of the Fedwire's hours of operation, increased use of routine intra-day settlements, cross-margining proposals, 24-hour trading, developments in the standardization of margin systems across exchanges and clearing organizations, and the potential effects of domestic foreign currency accounts on securities and futures settlements.

With respect to detection and deterrence of frontrunning and other intermarket trading abuses, the Commission and the futures exchanges have coordinated with the SEC and the securities exchanges efforts to conduct surveillance for possible intermarket frontrunning and other intermarket abuses. All futures exchanges that trade stock index futures contracts have interpretations and/or rules that prohibit intermarket frontrunning. The issuance and contents of these interpretations as well as that of the NYSE were coordinated so as to address intermarket frontrunning in the same manner. The CME and NYSE in March 1990 and the CBT and NYSE in December 1990 separately have established information-sharing agreements that provide for the daily exchange of certain agreed-upon surveillance information believed by each to be relevant to investigating intermarket abuses. Other futures and securities exchanges have established or are negotiating similar information-sharing arrangements.

Finally, the Commission and Commission staff participate in a variety of international organizations and committees which address issues related to harmonizing financial services regulation and international competitiveness. In addition, the CFTC and SEC have coordinated their efforts in negotiating a number of international information-sharing arrangements with foreign

regulatory counterparts. The Commission and Commission staff have also participated extensively in the activities of the International Organization of Securities Commissions, an international coordinating body for securities and derivative market regulators.

Q1(c). For each of the five intermarket issues contained in the Bond-Wirth Alternative, describe the actions already taken by the CFTC to implement those objectives?

A1(c). Such actions are referred to above and described more fully in the Commission's Intermarket Coordination Report dated May 31, 1991, which is required by the MRA.

Q1(d). For each of the five intermarket issues contained in the Bond-Wirth Alternative, what rules and regulations have yet to be adopted to fully implement those objectives?

A1(d). As noted above in responding to Q.1.(b), cross-margining is yet to be fully implemented beyond the limited systems now in operation.

Q1(e). Do you support this provision of the Bond-Wirth Alternative? If not, why?

A1(e). The Commission does not support this provision of BW. It is the Commission's view that the issues raised by BW, (1) coordinated circuit breakers, (2) cross-margining, (3) coordinated clearance and settlement systems, (4) detection and deterrence of frontrunning and other intermarket trading abuses, and (5) uniform policies with regard to negotiation and development of international regulatory agreements and standards involving intermarket issues, are being addressed and that, as the Senate Committee on Agriculture, Nutrition and Forestry concluded, the five intermarket directives set forth in BW are duplicative of the coordination and reporting requirements in the MRA.

Q2(a). How does the regulation of hybrid instruments in the United States compare with the regulatory scheme in foreign countries with major financial markets (e.g., United Kingdom, Japan, Germany, Canada).

A2(a). In the U.S., hybrid instruments may be defined as instruments that are part options and/or futures contracts and part debt, preferred equity or depository interests. The CFTC issued a Statutory Interpretation Concerning Certain Hybrid Instruments in which it recognized an exclusion from regulation under the Commodity Exchange Act for certain hybrid instruments meeting specified criteria. 55 Fed. Reg. 13582 (April 11, 1990). These criteria include, among others, that the instrument be indexed to a commodity on no greater than a one-to-one basis, that the amount of loss on the instrument due to fluctuations in the price of the referenced commodity be limited, and that the non-commodity related yield of the instrument be at least fifty percent but not greater than one hundred fifty percent of the estimated annual yield at the time of issuance for a comparable non-hybrid debt, preferred equity or depository instrument issued by the same or similar issuer. In addition, the CFTC, by rule, exempted from regulation under the Commodity Exchange Act hybrid instruments which have a commodity option component, and which meet a requirement, among others, that the value of the option's implied premium be no greater than forty percent of the issue price of the instrument. 17 C.F.R. Part 34 (1990).

In France, there is no separate regulatory program for hybrids of the type similar to those addressed by the CFTC. In the past, French bonds linked to the price of gold had been issued which, depending upon their terms, could have been characterized as a hybrid product not subject to regulation under the CFTC's regulatory definition of hybrids. Currently, warrants linked to the level of a stock index (CAC 40) are traded in France, subject to the supervision of the French securities organization, as opposed to the derivatives self-regulatory organization. Similarly, in the United States these instruments would be securities under the Johnson/Shad Accord.

In Japan, products defined as hybrids are not traded. However, the Ministry of Finance identifies pooled investment vehicles as hybrid products if the vehicle invests in, among other things, both futures and equities. Depending on the types of products traded, the vehicle could be regulated by one of three Japanese Ministries.

Since the principal focus of U.K. law is to regulate "investment business," the distinction between a hybrid product and, for example, a security is less relevant in the U.K. than in the United States. No explicit scheme for regulation of hybrid instruments exists in the United Kingdom, but to the extent that hybrid instruments are securities they will be "investments" and may be subject to regulation if dealt with as "investment busi-

ness" under the definition in Schedule 1 of the Financial Services Act of 1986. If hybrid instruments are bank loans or deposits they may be subject to the oversight of the Bank of England. There is no regulation of the terms of hybrid instruments. Not all market participants are required to report hybrid instrument transactions, although off-exchange trading in hybrid securities such as index warrants may be reportable to the Securities and Futures Authority or the Association of International Bond Dealers if traded by their members. Trading by institutions is not reportable.

Ontario's Commodity Futures Act pertains solely to exchange-traded, clearing corporation-interfaced commodity futures contracts and commodity futures options. Under Ontario's regulatory scheme, all other instruments, including hybrid instruments and forwards are "securities," and are regulated pursuant to Ontario's Securities Act. Hybrids are therefore subject to all of the prospectus, continuous disclosure and public interest requirements of the Ontario Securities Act.

Q2(b). Does any foreign country with major financial markets provide the regulator of commodity futures and options with exclusive jurisdiction over all instruments that provide a risk-hedging function? If so, how does the definition of a "futures contract" and "commodity" differ in those countries from the definitions in the Commodity Exchange Act?

A2(b). No jurisdiction with major financial markets grants to a single regulator exclusive jurisdiction over all instruments that provide a risk-hedging function. In this country, for example, the Commodity Futures Trading Commission has jurisdiction over futures contracts and commodity options. The Securities and Exchange Commission, however, has jurisdiction over options on equity index instruments, which also can provide a risk hedging function.

In France, the Marche a Terme International de France (the French International Futures Exchange) and the Options Market France are governed by the Conseil du Marche a Terme (Futures Market Council), while the Paris Traded Options Market is under the authority of the Conseil des Bourses de Valeurs (the Securities Exchange Council).

In Japan three separate ministries - the Ministry of Finance, the Ministry of International Trade and Industry, and the Ministry of Agriculture, Forestry, and Fisheries - each regulate certain futures products and the Ministry of Finance also regulates certain securities products. The nature of the particular product involved determines the regulator for that particular product.

In the United Kingdom, investment business, including futures and option transactions, is governed by the Financial

Services Act, which establishes the framework for the regulatory structure currently in effect in the United Kingdom. Under this structure, the Securities and Investments Board, pursuant to powers delegated by the United Kingdom Secretary of State for Trade and Industry, is responsible for monitoring and enforcing compliance with its rules, which essentially are directed at the regulation of market professionals rather than a particular class of product. Although in general investment business is regulated by the SIB, to the extent a transaction is a bank transaction - such as a swap transaction - the parties involved will fall under the regulation of the Bank of England.

Q2(c). Does any foreign country with major financial markets require that all commodity futures and options trade solely on designated contract markets? Are over-the-counter futures markets permissible in other markets?

A2(c). Generally, in Canada, France, Japan and the United Kingdom, futures and option products must trade on or subject to the rules of a recognized exchange.

For example, the Japanese Securities and Exchange law requires that all transactions take place on an exchange, except for over-the-counter trades in Japanese Government Bond options. Otherwise off-exchange transactions are permitted only if needed for correction, and special permission of the exchange is required. In Ontario, Canada all commodity futures transactions must take place on the exchange floor except for certain kinds of cross trades and exchange-for-physicals transactions permitted under the rules of the Toronto Futures Exchange.

However, in France, traders are allowed to negotiate contracts when the floor of the exchange (the Marche a Terme International de France) is closed and to record those transactions with the clearing house the following day. Further, in the United Kingdom, business, experienced or professional investors may engage in margined futures transactions which are not made on or under the rules of an exchange, so long as a special risk disclosure document is provided to the customer.

Q2(d). To what extent does the regulatory scheme governing hybrid instruments in the United States impede the international competitiveness of U.S. markets?

A2(d). There is no evidence to suggest that the regulation of hybrid instruments in the United States impedes the competitiveness of United States markets. Initially, it should be noted that the regulation of hybrid instruments in the United States is not the subject of a separate regulatory scheme. Depending upon its characteristics, a hybrid instrument will be characterized either as a security or a futures or commodity option product and be regulated under existing securities or futures legislation, respectively. In this regard, in an effort to facilitate the

characterization of such products and eliminate any obstacles to their marketing, in 1990 the Commission issued a statutory interpretation clarifying the circumstances under which a hybrid instrument would not be regulated under the Commodity Exchange Act. See 55 Fed. Reg. 13582 (April 11, 1990). Moreover, the Commission notes that at no time did the regulatory structure in the United States prohibit a hybrid product from trading. For those products falling within the Commission's jurisdiction, an exchange desiring to offer such products would need only to apply for designation as a contract market. In addition, the Commission repeatedly expressed its willingness to expedite treatment of any application for exchange trading designation of a hybrid financial product, if the off-exchange trading of such products would be contrary to existing law and relief could not otherwise be made available.

Q2(e). Have any hybrid financial products (i.e., instruments with any element of "futurity" or attributes of commodity options or futures contracts) developed in the United States been issued or traded in foreign markets? If so, describe the product and the reason that it was issued or traded abroad.

A2(e). The Commission is not aware of any hybrid product that was developed in the United States but which was first issued or traded abroad. In this regard, the Commission notes that so-called index participations should not be considered a hybrid product, since index participations are futures contracts. Furthermore, this distinction was recently upheld in a court decision. Although an instrument called an index participation was introduced on the Toronto Exchange, that product - the Toronto 35 Index Participation Unit - involves units of a trust, the Toronto 35 Index Participation Fund, which was created by the Toronto Exchange. The Toronto Stock Exchange structured these units to be deemed to be "securities" under Canadian law and the Commission believes that such units similarly would be regulated as securities under United States law were they to be traded in the United States.

Q2(f). What modifications to the federal commodity and securities laws would enhance the competitiveness of United States financial markets?

A2(f). The Commission believes that in general the Commodity Exchange Act and the Commission's rules are consistent with the public interest and serve the needs of all market users, foreign and domestic. The Commission, however, believes that the limited authority to grant exemptions from the exchange trading requirement for futures contracts contained in S.207 would enhance U.S. financial market competitiveness. Further, although the Commission believes that its rules have contributed to the international competitiveness of United States financial markets, the Commission is reviewing certain rules to ensure that the Commission meets its oversight objectives in a cost-effective

manner that does not inadvertently stifle innovation. This does not mean, however, that we seek the lowest costs or least amount of regulation, as we intend to maintain our high standards of quality with respect to the regulation of futures products. In the long term, we believe that maintaining the safety of United States markets and continuing to encourage innovation will contribute to maintaining the competitiveness of our financial markets.

Q3. The Bond-Wirth Alternative would exclude from the federal commodity laws bank deposits and loans made by federally insured depository institutions.

(a) Do you support these provisions? If not, why not?

(b) Under current federal and state banking laws can banks convert loans and bank deposits into futures contracts? If so, how?

A3(a). In fact, the Bond-Wirth Alternative excludes not only bank deposits and loans made by federally regulated depository institutions but also consumer credit transactions subject to the Truth in Lending Act. This would include credit transactions with department stores, auto dealers, household finance companies, pawn shops or other companies.

Consistent with Administration policy in other areas, such as banking and securities, we support functional regulation. These provisions are inconsistent with that approach and we do not support the exclusion.

A3(b). If a bank developed a deposit instrument whose rate of return or loss was linked solely to price movements in wheat, this instrument might be a futures contract. If so, the bank would be in violation of the Commodity Exchange Act if these deposits were not offered and traded on an exchange. We would defer to the appropriate banking regulators on the issue of whether such conduct would also violate federal or state banking laws.

Q4. S.207 provides the Federal Reserve Board with federal oversight of margins on stock index futures.

(a) Do you believe that federal oversight of stock index futures margins is warranted? Is so, why?

(b) Under S.207, the Fed may direct changes in the level of margins "to prevent systemic risk." Do you believe that margins on stock index futures can cause systemic risk? If so, how?

(c) What, if any, changes in the current margining system for stock index futures would you recommended? Why?

A4. The Commission believes that section 301 of S. 207 strikes an appropriate balance between the interest of the individual futures exchanges in maintaining day-to-day control over futures margin levels and the federal government's interest in assuring that the exchanges react promptly and appropriately to protect each market's financial integrity and to prevent systemic risk.

Futures margins exist to preserve financial integrity of each market or clearing system by limiting the financial exposures of clearing organizations, futures commission merchants, brokers, and banks. This is accomplished by reducing the probability of customer default by ensuring that margin levels are adequate to provide protection against a high percentage of position losses resulting from adverse price movements. Thus, systemic risk can be defined as a threat to the financial integrity and stability of the system resulting from widespread defaults due to a number of factors, including margins inadequate to compensate for losses. Systemic risk could therefore be present in any type of market in which margin levels did not provide a sufficient degree of protection. S.207 provides a mechanism for assuring that this risk is considered in margin-setting decisions.

However, the Commission continues to agree with the conclusion stated by the working group in its Interim Report of the Working Group on Financial Markets that "current minimum margin requirements provide an adequate level of protection to the financial system..." Therefore, we see no need for fundamental changes in the way exchanges set their margins. S.207 contains no such changes, but explicitly pr des for federal oversight.

Q5. In your testimony (at page 15) you state that "life insurance policies have elements of "futurity" but have never been considered futures contracts by the CFTC or the courts." In your letter of April 15th, you add that "the Commission has never asserted that traditional insurance products are futures or options contracts."

(a) Since the CFTC does not believe that insurance products are subject to the Commodity Exchange Act, shouldn't Congress make it clear that insurance products are excluded from regulation under the federal commodity laws? if not, why not?

(b) Are insurance companies authorized under state insurance laws to issue futures contracts?

A5(a). No, we do not believe that legislation is needed to exclude products from regulation by the Commission. Enactment of statutory exclusions are only appropriate where there is substantial ambiguity or the danger of a clash between two existing regulatory schemes. Neither has occurred under the Commodity Exchange Act in the case of insurance. Many contracts that have elements of "futurity" are not futures contracts. Forward contracts -- i.e., contracts for deferred shipment or delivery -- are the most prominent example of a contract with "futurity" that is not a futures contract. Similarly, mortgages and life insurance policies also have elements of "futurity" but have never been considered futures contracts. If, however, an insurance company developed and marketed to the public an instrument which in fact was a futures contract, the firm would be violating the Commodity Exchange Act and might be in violation of state law as well.

A5(b). In general, there is no "issuer" of a futures contract; rather a party enters into a futures contract and agrees to make or take delivery of a commodity some time in the future. State laws govern the extent to which insurance companies can enter into futures contracts. The Commission understands that states often permit insurance companies to use the futures markets to hedge their investment portfolios.

Q6. The Bond-Wirth amendment makes clear that swap agreements that are not standardized or fungible because they are individually negotiated between institutional or sophisticated parties are not subject to regulation under federal commodity laws.

(a) As a practical matter, is it possible to trade individually negotiated swap agreements that are not fungible or standardized on a futures exchange?

(b) In your view, are swap agreements that meet the three criteria in the Bond-Wirth Alternative "futures contracts?"

(c) If not, why shouldn't Congress clarify that these swap agreement are not subject to regulation under the federal commodity laws?

A6(a). It is possible to trade agreements or instruments which are not standardized or fungible provided that parties to the agreement consent to the transfer and parties trading the instruments can agree on relative values. Standardization and fungibility are hallmarks of futures and stock exchange trading as it exists today. Standardization and fungibility assist in making trading more efficient and liquid.

A6(b)(c). In issuing its July 1989 Policy Statement Regarding Certain Swap Transactions, the Commission determined that swaps meeting the criteria set forth therein were not appropriately regulated as futures contracts. Given the broad definition of swap used in S. 207 and derived from the Bankruptcy Code, the Commission is concerned that, without the additional criteria enumerated in Section 302 of S.207, a "swaps" label can be applied to a futures contract which could be traded on an unregulated exchange. The Bond-Wirth criteria appear broader than those in the Policy Statement and in the version of S.207 supported by the Commission.

Q7. In your testimony (at page 3) you state that S.207 "confirms the traditional, functional regulatory roles" of the CFTC and SEC. You go on to explain (at page 12) that the traditional function of the CFTC is to regulate hedging and price discovery instruments.

(a) Are all instruments used to hedge risk currently regulated by the CFTC?

(b) Doesn't the $3 trillion dollar market in options on securities, which is currently regulated by the SEC, serve the function of hedging and price discovery?

(c) Aren't forward contracts, which are used to hedge risk, expressly excluded from CFTC regulation under the Commodity Exchange Act?

(d) If the CFTC does not currently regulate all instruments which are used for hedging risks, why should Congress adopt a functional regulation test that requires all new innovative financial instruments used for hedging to be regulated solely by the CFTC?

A7(a)(b). The market for options on securities and on securities indexes to which you refer does perform a hedging and price discovery function. However, the SEC today regulates these markets through enactment of a statutory exception to the general Congressional policy of functional regulation: the Johnson-Shad Accord.

A7(c). Yes, they are excluded from regulation as futures contracts. Forward contracts are essentially used to move commodities into the stream of commerce. They are entered into by commercial entities which use the commodity in their businesses. The parties contemplate delivery, have the capacity to deliver, and delivery routinely occurs.

A7(d). Passage of S. 207 is not a question of Congress adopting a new functional regulatory approach, but rather of adhering to the approach which it has historically taken for financial regulation. Functional regulation has been in place for futures since 1922 and for securities since 1933 and was departed from only in 1982 through enactment of the Johnson-Shad Accord.

Q8. In your letter dated April 15th, you claim that the "extremely broad exemptive authority proposed in the Bond-Wirth Alternative amounts to a directive to the CFTC to allow futures to be traded off-exchange regardless of the identity of the participants and the purposes of the transaction."

However, under the Bond-Wirth Alternative the CFTC may only grant exemptions which it determines are consistent with the public interest. At page 11 of your testimony you state that public interest tests "embody a well-established legal principle." You go on to state:

> In the Commodity Exchange Act the public interest considerations focus on provisions concerning price discovery, hedging and risk management for those engaged in the business of buying and selling commodities; market integrity concerns such as manipulation and excessive speculation; and of course, customer protection issues such as segregation of funds, antifraud and private rights of action and reparations.

You conclude that the CFTC has little difficulty devising rules to implement the public interest standard.

Why can't the CFTC implement broad exemptive authority consistent with a public policy standard?

A8. The Commission could implement such a broad exemptive provision, but the real issue here is the terms of the provision. In devising legislative language to permit exemptions from existing statutory requirements it is important to be mindful of the public interest considerations underpinning those requirements. S. 207, as reported by the Senate Agriculture Committee, explicitly addressed the type of public interest considerations I referred to in my testimony. S. 207 empowers the Commission to grant exemptions with due regard to the purposes and participants in exempted transactions. In contrast, the Bond-Wirth Alternative, as a substitute for S. 207, would delete such specific considerations from its exemptive language. This creates an inference that Congress was now somehow indifferent to the type of public interest considerations that have been an integral part of futures regulation for 70 years. Furthermore, the Bond-Wirth Alternative states "The Commission . . . shall . . . exempt any agreement, contract, or transaction (or class thereof)." (Emphasis added.) This language amounts to a directive to the Commission to allow futures to be traded off-exchange regardless of the identity of participants and the purpose of the transaction. For these reasons, the Bond-Wirth Alternative is unacceptable.

Q9. In S.207, there are exemptions from the Commodity Exchange Act for swap transactions and bank products.

(a) Can the CFTC revoke the exemption once it is granted?

(b) How can Congress be assured that a future Chairman of the CFTC won't decide to revoke an exemption granted by your Commission?

A9(a)(b). With respect to the exemptions in S.207 for swaps and bank products, the legislation itself sets forth specific conditions which must be satisfied in order for the exemption to apply. In this regard the CFTC, like any agency, may revoke an exemption if the terms of the exemption do not continue to be met. As you know, the CFTC is a five member commission which acts by a majority vote not by sole action of its Chairman. To date, the Commission has never revoked a regulatory exemption it has issued.

Q10. In Example 2 in Appendix A to your testimony, you describe a five-year bond with the principal repayment dependent upon whether the price of oil exceeds or is less than the price of $25 a barrel, times 40 barrels. With hypothetical equivalent yields for five year bonds at 10%, you found that the commodity futures component was 45% of the value of the instrument. Suppose that a virtually identical instrument was proposed, but that the time to maturity was ten years.

(a) What would that do to the valuation calculation?

(b) Would the instrument still pass the 50% test?

(c) What policy warrants treating a bond issuer differently if it issues a ten year bond instead of a five year bond?

A10. See response to Q.11. below.

Q11. In Example 4 in Appendix A to your testimony, you described SOHIO's Oil-Indexed Notes with a 4.5-year maturity with principal repayment at $1,000 plus the amount the price of oil is above $25 per barrel for 170 barrels, with a cap of $40 per barrel. You found that the value of the commodity option was 33% of the value of the notes. Suppose that the principal repayment was not capped at $40 per barrel, and the Notes were for ten years.

(a) What would that do to the valuation calculation?

(b) Would the instrument still pass the 50% test?

(c) What policy warrants treating SOHIO notes differently if it issues:

(1) a capped note as opposed to an uncapped note?

(2) a ten-year note instead of a 4.5-year note?

A11. Underlying both questions 10 and 11 is the assumption that the referenced instruments are "identical" but for such minor differences as maturity and the placement of caps and floors. Such differences, however, are not minor. For example, time to maturity is one of the primary factors in pricing debt instruments. A six-month loan will have a (sometimes significantly) different interest rate than a ten-year bond. As a reflection of this, short-term commercial paper is subject to different regulatory treatment than longer-term debt. Similarly, both a hybrid's maturity and the extent to which the hybrid's commodity price payoff is constrained (by caps or floors) are characteristics which directly affect the nature of the commodity price play inherent in the instrument. An increase in the maturity of a bond to which is attached a futures or option component will necessarily increase the extent of commodity play inherent in the resulting hybrid instrument since the extended maturity will increase the opportunities for observing a larger move in the hybrid's referenced commodity price. If maturity were a minor issue, then issuers of plain vanilla debt would be indifferent to choice of maturity. The choice of maturity in a hybrid is even more significant because the return on the instrument becomes more closely related to the commodity price the longer the maturity. An issuer of a long-dated hybrid will surely have intended this to be the case, indicating an intent to issue an instrument that is more commodity-like.

Likewise, removing caps or floors from the commodity component of a hybrid instrument increases the probability of greater commodity based payoffs (as well as greater commodity based losses in the case of a futures component) from the instrument; whereas the addition of such constraints obviously <u>reduces</u> the instrument's inherent price play. For example, a cap and a floor set at the same price would reduce an instrument's commodity

price play to zero. Since the 50% test attempts to distinguish between hybrids containing little commodity price play and those containing a significant amount, the instrument's maturity and use of caps or floors are highly relevant to that distinction and determine whether an instrument's value derives predominantly from its commodity characteristics.

Q12. In Example 4 in Appendix A to your testimony, suppose that the instrument issued by SOHIO was structured as a warrant rather than a note.

(a) What would that do to the valuation calculation?

(b) Would the instrument still pass the 50% test?

(c) What policy warrants treating SOHIO differently if it issues a note as opposed to a warrant?

A12. The term warrant is typically used as an alternative for an option. Hence, if the SOHIO instrument were structured as a warrant, the 50% test would not be applicable because that warrant is not a hybrid. The instrument would simply be a long-dated commodity option whose returns depended upon future commodity price moves.

Q13. In Example 4 in Appendix A to your testimony, the exclusion of SOHIO oil-indexed notes from the Commodity Exchange Act under the 50% test would be inversely related to the price of oil. According to the attached chart, during the month of August 1990, notes similar to those described in example 4 would have been excluded from the CEA for 18 days and within the CEA for 13 days.

What policy warrants the same debt instrument when issued to be regulated on some days as a future and on others as a security based solely on the fluctuating price of a commodity?

A13. The exhibit to Q.13 reflects a basic misunderstanding of pricing in futures markets and a misapprehension of the way in which the predominant purpose test is applied. First, since the maturity of the hybrid instrument is 3.5 years, the proper futures price to use in measuring the commodity component is a long-dated futures price, not the spot-month futures price of crude oil. Using the spot-month futures price would be similar to shopping for a 30-year mortgage by looking at T-bill rates. Second, the analysis assumes that the overall price of the hybrid remains constant when the price of the commodity changes, thereby misstating the representation of the commodity play in the instrument. In the context of the exhibit, this error results in an overstatement of the commodity representation. As an analogy, if one were to purchase an apple and orange for 3 cents and 5 cents, respectively, the total cost of the two would be 8 cents, of which the apple would represent 37.5% of the cost. If the price of the apple were to rise to 4 cents, the total cost of the two is 9 cents and the apple represents 44.4% of the cost. If instead we continued to use the methodology of the exhibit and thus assume, erroneously, that the total cost remained 8 cents, then it falsely appears that the apple represents 50% of the cost.

We reevaluated the example correcting these fundamental errors. First, we used the longest dated futures trading in August 1990. (Note that this contract had a maturity of 2 years and 3 months, which would still overestimate the commodity component assuming normal backwardation in the market.) The same volatility and interest rates were assumed as in the exhibit. Second, we adjusted the overall value of the instrument for changes in the value of the commodity component. Doing this we found that, contrary to the claim made in the example, the commodity component never exceeded 50% of the value of the instrument during the month. Therefore, under the 50% test the instrument would at no time have been deemed subject to regulation under the CEA. In fact, when analyzed correctly, the commodity component averaged only 29% of the total value of the instrument during the month.

Q14. In determining the "value" of an "embedded futures" contract, your proposed test would add together the premium associated with a hypothetical short put option with the premium associated with a hypothetical long call option. However, a traditional futures contract is priced based only on the cost of carry and has no intrinsic value in and of itself.

(a) If a customer used options to create a synthetic future, would the customer pay a premium to obtain a long call and receive a premium for selling the short put?

(b) If so, shouldn't the values of the premiums be netted in arriving at the value of the imbedded synthetic future (i.e., subtract the long call from the short put premium)? If not, why not?

A14(a). A customer would obtain a long call and a short put only to create a synthetic long future. To create a synthetic short future the customer would buy a put and write a call.

A14(b). Yes. However, the 50% test does not attempt to measure a futures' value, but rather measures the amount of commodity play that is embedded in a hybrid instrument. Further, the measure used is designed to yield consistent results with option-only hybrids and futures-only hybrids, and combination hybrids. In doing so, the 50% test measures the sum of the absolute values of the premiums for the options constituting the embedded synthetic future. Consider the following example: A hybrid is issued containing a bond with a face value of $1,000 and a futures with a current value of $0 (long call and short put with strikes at the current relevant futures price). Assume each option is worth $100 and that the bond's value is $1,000. To avoid creating adverse incentives in the design of hybrids, this instrument should be, and under the predominant purpose test would be, treated the same as a portfolio consisting of (1) a bond with a face value and market value of $500 and a long call worth $100, and (2) a second bond with a face value and market value of $500 and a short put worth $100.